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### Tax treaty override

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# **Tax Treaty Override**

Carla De Pietro

Co-directed PhD between ALMA MATER STUDIORUM  
– University of Bologna and Tilburg University

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Carla De Pietro

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# Tax Treaty Override

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Promotores: Prof. dr. P.H.J. Essers  
Prof. A. Di Pietro

Overige leden Prof. dr. J.A.G. van der Geld  
Prof. Emer. dr. J. Malherbe  
Prof. dr. A. Tanzi  
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*Alla mia mamma, con l'amore di sempre*



# Tax Treaty Override

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# Chapter I

## *Introduction: a study about tax treaty override*

### **1. Scope of the study: the need of a legal systematization of tax treaty override**

Although tax treaty override is a quite frequent phenomenon in practice, until now no academic studies have provided a systematic analysis about this topic. The Report on treaty override elaborated by the OECD in 1989<sup>1</sup> was a quick reaction to the grave cases of tax treaty override that occurred in the United States in the 1980's. However, this report is mostly the result of a political more than legal approach to tax treaty override. There is only one available monographic book<sup>2</sup> about tax treaty override. It was published in 1998 and is essentially an interpretative analysis of tax treaty override under German legislation. More recently, Prof. Maisto has edited a volume which is part of the 'EC and International Law Series'<sup>3</sup>. This volume, which is dedicated to 'Tax Treaties and Domestic Law', also deals with tax treaty override but only as a part of the wider problem concerning the relationship between tax treaty provisions and national law.

Despite its theoretical and practical implications, tax treaty override has not been analyzed yet in a systematic way. On the contrary, the analysis about tax treaty override is still at a preliminary stage.

My purpose in this study is to identify the interpretative process that underlies the detection of cases of tax treaty override. As a consequence – and in parallel – the definition of tax treaty override will be developed to clarify some aspects that are still unclear or not taken into consideration both in literature and case law. This analysis will be conducted in order to develop an 'interpretative model' on which the individuation of cases of tax treaty override can be based.

Starting point of this analysis are the definitions of tax treaty override that have been elaborated in literature and practice<sup>4</sup>. The following overview will show

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<sup>1</sup> OECD Committee on Fiscal Affairs, *Tax Treaty Override*, 1989.

<sup>2</sup> Mausch, V., *Treaty Overriding*, Shaker, 1998. It is, instead, out of print, Musil, A., *Deutsches Treaty overriding und seine Vereinbarkeit mit europäischem Gemeinschaftsrecht*, Duncker & Humblot, 2000.

<sup>3</sup> Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006.

<sup>4</sup> This analysis also takes into consideration: OECD Committee on Fiscal Affairs, *Tax Treaty Override*, 1989; Senate Report 100-445, 100<sup>th</sup> Cong., 2<sup>nd</sup> Sess., Tit. I, XII H 1

how many uncertainties still characterize the definition of tax treaty override and consequently the development of an interpretative process aimed at its concrete identification. However, at the same time, these definitions are extremely precious because they delineate a basic concept of tax treaty override which constitutes the foundation of this study. In addition, these definitions give rise to important issues which are an extremely helpful indication about the connotation that tax treaty override is assuming.

In this regard, it is important to clarify that in general international law the term ‘treaty override’ refers to any breach of an international treaty according to the common meaning of the verb ‘override’<sup>5</sup> (or its synonym ‘overrule’ which is also used).

Only for tax law purposes the term ‘treaty override’ has assumed a specific connotation. Tax lawyers define treaty override as a breach of one or more provisions of a valid international treaty through the enactment of subsequent national law which is in conflict with those treaty provisions<sup>6</sup>. It can be said that

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(Relationship with Treaties), explaining Sec. 112 (aa) of S. 2238 (IRC Sec. 7852) (the ‘Senate Report’).

<sup>5</sup> Wehmeier, S. (editor), Oxford Advanced Learner’s Dictionary, Oxford University Press, Sixth Edition: ‘override: 1 To use your authority to reject sb’s decision, order, etc. SYN. OVERRULE ...’; ‘overrule: to change a decision or reject an idea from a position of greater power ...’

<sup>6</sup> Ex multis, see ‘TREATY OVERRIDE’ in Larking, B. (editor), IBFD International Tax Glossary, fifth edition 2005, p. 425–426: ‘Treaty override has been described in a tax context in terms of “the enactment of legislation which is intended to nullify unilaterally the application of international treaty obligations” (OECD). In a less technical sense the term is sometimes used to refer to a number of situations, including legislation which reverses a judicial decision which conflicts with the legislature’s interpretation of the treaty, a change in the definition of a term used under domestic law as a result of which the meaning of a treaty term (generally the same term) also changes through operation of the treaty provisions for interpreting undefined terms, and a change in domestic legislation which unintentionally conflicts with a treaty provision ...’; Rohatgi, R., *Basic International Taxation*, Second Edition, Volume I: Principles of International Taxation, Richmond Law and Tax Ltd, Second Edition 2005, p. 336 (Appendix – Glossary of International Tax Terms): ‘Treaty override is a term used when a subsequent law or action conflicts with prior treaty obligations. As a rule, the provisions of a tax treaty prevail over domestic legislation even if the provisions conflict. In some countries the relationship between treaties and domestic law is governed by the “last in time” rule, i.e. if there is a conflict between a treaty and domestic legislation, the last in time prevails. In recent years, certain countries have enacted legislation designed to specifically override treaty provisions. Because treaty overrides potentially undermine existing treaty obligations, they have been the subject of intense criticism’; Ault, H. J. – Arnold, B. J. (Principal Authors), *Comparative Income Taxation – A Structural Analysis*, Second Edition, Kluwer Law International, 2004, p. 428; Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 67; Roxan, I., *Judicial Overrides of Double Tax Conventions: The Case of a Permanent Establishment*, in *Intertax*, Vol. 25 (1997), No. 11, p. 367: ‘The international tax community has for some time been concerned by the use of domestic legislation by a number of countries to override unwelcome provisions of double tax conventions. Such provisions are often termed ‘legislative overrides’. **They are in effect**

one or more provisions of an international treaty are unilaterally amended by subsequent national provisions.

Vogel wrote: *‘When a legislature unilaterally enacts new domestic tax laws which are contrary to an existing treaty without the treaty having been amended or terminated, such legislative action is then a violation of the treaty under international law. This type of treaty-violating legislation has become known as a “Treaty Override”’*<sup>7</sup>.

Thus, tax treaty override originates from a conflict between international treaty provisions and subsequent national law provisions which are considered to be prevailing under the relevant state’s legislation.

The 1989 OECD Report on tax treaty override states that *‘the term “treaty override” refers to a situation where the domestic legislation of a state overrules provisions of either a single treaty or all treaties hitherto having had effect in that State. Legislation may take the form of a provision that treaty provisions are to be disregarded in certain circumstances (e.g. in cases of treaty shopping or other forms of abuse). Legislation can also have the effect of overriding treaties, even where no reference is made in the legislation to treaty provisions as such, because the domestic interpretation of the effect of that legislation in relation to treaty provisions has the same effect in practice’*<sup>8</sup>.

This wide OECD definition of treaty override is not surprising given that the Report was adopted as a reaction to the serious cases of treaty override which were occurring in the U.S. in the 1980’s and mostly to the ‘Senate Report’<sup>9</sup> which accompanied the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) and largely allowed treaty override in the United States<sup>10</sup>.

This definition of the OECD clarifies that the purpose of preventing abuse of treaties cannot – at least according to the OECD’s position – justify the enactment of a law that is overriding previous treaty provisions. Thus, according to the OECD, formal criteria seem to prevail over substantive evaluations concerning the safeguard of legitimate purposes<sup>11</sup>.

*unilateral amendments to international treaties [emphasis added]*’; OECD, *Tax Treaty Override*, OECD 1989, p. 5. See also the *Recommendation of the Council concerning Tax Treaty Override*, adopted on the 2<sup>nd</sup> of October 1989, Annex A to the OECD Report *Tax Treaty Override*, cit. The Council recommends *‘to avoid enacting legislation which is intended to have effects in clear contradiction to international treaty obligations’*, OECD, *Tax Treaty Override*, OECD 1989, p. 17.

<sup>7</sup> Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 67.

<sup>8</sup> OECD, *Tax Treaty Override*, OECD 1989, p. 5

<sup>9</sup> Senate Report 100-445, 100<sup>th</sup> Cong., 2<sup>nd</sup> Sess., Tit. I, XII H 1 (Relationship with Treaties), explaining Sec. 112 (aa) of S. 2238 (IRC Sec. 7852) (the ‘Senate Report’).

<sup>10</sup> Cfr. Avi-Yonah, R. S., *Tax Treaty Overrides: A qualified Defence of U.S. Practice*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 65 *et seq.*

<sup>11</sup> This topic will be specifically treated in chapter II.

There are, however, also authors who consider the need to curb tax avoidance and tax evasion as a justification for treaty override<sup>12</sup>.

It is also worth noting that the OECD has attributed unlawful overriding effects to an interpretation that results in the application of a law conflicting with a previous treaty. This should corroborate the distinction between ‘legislative treaty override’ and ‘judicial treaty override’<sup>13</sup>. In the first case, a domestic law has the effect of overriding a previous treaty at the moment of its approval by a national parliament. In the second case, the overriding effect of domestic law depends on the interpretation given by a judge which results in a conflict with a previously concluded international treaty.

From the OECD position it could also be inferred the appropriateness to favour an interpretation of law which does not violate previous treaty provisions (when different interpretations are possible)<sup>14</sup>.

Bartlett points out “... *there is a danger of taking too simple a view on treaty override. The words cover a multitude of occasions. At its weakest, the term could be used to apply to a unilateral treaty modification by domestic law which was acceptable to the partner country but not in fact negotiated with it. Next up the scale comes specific treaty override. This is illustrated by the case where the domestic law overrides only particular and named aspects of treaties. One has to be a little careful in passing judgment on action falling within this category. They can amount to no more, as was the case with the Padmore legislation in the United Kingdom, than a provision designed simply to restore a prior view of the application of the law. Next on the rising scale comes the general treaty override which does not, however, amount to a treaty breach and top of the list comes general treaty override which amounts to a treaty breach.*”<sup>15</sup>

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<sup>12</sup> See, for example, Avi-Yonah, R. S., *Tax Treaty Overrides: A qualified Defence of U.S. Practice*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 65 – 80.

<sup>13</sup> Roxan, I., *Judicial Overrides of Double Tax Conventions: The Case of a Permanent Establishment*, in Intertax, Vol. 25 (1997), No. 11, p. 367: ‘A more difficult problem [more difficult than legislative override – author’s addition] arises where a court gives effect to domestic tax legislation in a way that overrides the terms of a tax convention. This may be termed a ‘judicial override’. A judicial override may arise because a court is suspicious that provisions of the convention may have a ‘disruptive’ effect on the domestic tax system. More innocently, it may arise simply because the court is less familiar with the interpretation of tax conventions than with the interpretation of domestic tax legislation. The court may thus find it easier to reach a conclusion by applying purely domestic tax principles.’

<sup>14</sup> See Wouters, J. – Vidal, M., *The International Law Perspective*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 20: ‘Municipal judges ... typically engage in so-called “consistent interpretation”, i.e. an interpretation of domestic law in conformity with the treaty in question, departing from the ... presumption that the legislature did not intend to violate the State’s international obligations.’

<sup>15</sup> Bartlett, R. T., *The Making of Double Taxation Agreements*, in British Tax Review (1991), No. 3 – 4, pp. 83-84.

Interestingly, Bartlett accepts as legitimate some forms of treaty override, although without clarifying which forms of ‘general treaty override’ can be considered valid.

This view is in contrast with Vogel’s definition which does not admit any legitimate form of treaty override. According to Vogel, treaty override is – in itself – a violation of international law<sup>16</sup>.

Both authors – although Bartlett only indirectly – emphasize the importance of a long-term uncontested interpretation by suggesting that a treaty override may occur when parliament adopts a national law which officially aims at clarifying the meaning of an already existing law but – in fact– changes the previously consistently accepted interpretation.

Thus, in contrast with the OECD Report on treaty override<sup>17</sup>, Vogel holds that ‘hidden treaty overrides’ can occur: ‘... if a bill contradicts a longstanding interpretation of a treaty **which had never previously been contested** and the bill is claimed to only ‘clarify’ the meaning of the treaty, there is every indication that in reality nothing less than a ‘treaty override’ has been intended. It is also suspect when legislation is supposed to merely rectify the result of an allegedly incorrect **judicial decision**. Occasionally, such a law may really be intended to only restore the true meaning of a treaty (as happened in the view of this commentary, with the Canadian decision in the Melford case<sup>18</sup> ...). However, this is very unlikely when such ‘corrections’ are undertaken **more frequently** (as in the UK ... even still during a pending decision in *Padmore v. IRC*<sup>19</sup>... Contrary to the view of the OECD Committee on Fiscal Affairs ... such adjustments may certainly be **hidden treaty overrides** [Vogel’s emphasis].’<sup>20</sup>

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<sup>16</sup> Vogel took explicitly position against Bartlett’s broad definition: “A ‘harmless’ treaty override, i.e. one which remains under the threshold of a violation of international law (see Bartlett, R. T., B. T.R 76, 83 (1991)), is not conceivable under this definition.” See, Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 67.

<sup>17</sup> OECD, *Tax Treaty Override*, OECD 1989, pp. 5–6, lett. a).

<sup>18</sup> The Melford case deals with the interpretation of art. 3(2) of the OECD Model Convention. See *infra* chapter IV.

<sup>19</sup> In the *Padmore* case (*Padmore v IRC* (1987) *STC* 36 affirmed by the Court of Appeal (1989) *STC* 493) the Court of Appeal of London excluded that an individual resident in the UK and partner in a foreign partnership could be subjected to income tax in the UK. The consequences of this decision were immediately nullified with the Finance Act (No. 2) 1987. It introduced a new subsection (4) in section 153 of the Income and Corporation Taxes Act 1970 containing the express provisions that UK resident partners in foreigner partnerships had no right to obtain exemption from income tax under an international tax treaty. The Act even conferred retroactive effect to the provision. It is important to emphasize that while Vogel considers the legislation that superseded the decision taken in the *Padmore* case an hidden treaty override, completely at the opposite, Bartlett excludes that a treaty override was realized by that legislation.

<sup>20</sup> See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, pp. 68–69.



There are, furthermore, different positions about the necessity that the overriding law expresses the legislature's will to override an international treaty. The OECD considers a treaty override occurring when a legislature explicitly expresses its intention to override a previous treaty<sup>21</sup>. At the opposite, the U.S. 'Senate Report' allows treaty override in the U.S. when there is a conflict with a previous treaty, although no overriding will has been expressed by the legislature<sup>22</sup>.

It is worth noting that this position of the OECD is clearly in contradiction with the previously mentioned statement according to which: '*... Legislation can also have the effect of overriding treaties, even where no reference is made in the legislation to treaty provisions as such, because the domestic interpretation of the effect of that legislation in relation to treaty provisions has the same effect in practice.*'<sup>23</sup>

Finally, it is important to highlight that, according to the OECD, treaty override occurs at the moment that national law is passed by the legislature. The actual application of the relevant national provisions is, therefore, not necessary in order to breach an international treaty<sup>24</sup>. However, some authors have maintained that, even if national legislation is formally in conflict with a previous treaty, only its actual application determines a violation of international law<sup>25</sup>.

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<sup>21</sup> OECD, *Tax Treaty Override*, OECD 1989, p. 6.

<sup>22</sup> 'Senate Report', cit.: '*... The Committee believes it would be erroneous to assert that an income tax statute ... prevails over treaties only if treaty interactions are mentioned in the statute or legislative history. On the other hand, the committee believes that any such mention, if made, would be dispositive.*

*In view of what the committee believes is the correct treatment of treaty- statute interaction, then, the committee finds it disturbing that some assert that a treaty prevails over later enacted conflicting legislation in the absence of an explicit statement of congressional intent to override the treaty; that it is treaties, not legislation, which will prevail in the event of a conflict absent an explicit and specific legislative override. The committee does not believe this view has any foundation in present law. Moreover, the committee believes that it is not possible to insert an explicit statement addressing each specific conflict arising from a particular act in the act or its legislative history; for in the committee's view, it is not possible for Congress to assure itself that all conflicts, actual or potential, between existing treaties and proposed legislation have been identified during the legislative process of enacting a particular amendment to tax laws. In the absence of a clear statement that legislation prevails over prior treaties, dubious tax avoidance schemes, in the committee's view, have been suggested. See, e.g., Tax Notes, March 9, 1987, at 1004, improperly suggesting that the failure to clarify the relationship between the Subchapter S Revision Act of 1982 and earlier treaties allows foreigners to own and operate U.S. business tax-free.' See Avi-Yonah, R. S., *Tax Treaty Overrides: A qualified Defence of U.S. Practice*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 73.*

<sup>23</sup> OECD, *Tax Treaty Override*, OECD 1989, p. 5.

<sup>24</sup> OECD, *Tax Treaty Override*, OECD 1989, p. 6.

<sup>25</sup> Wouters, J. - Vidal, M., *The International Law Perspective*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV,

This brief examination has showed that there are still many conflicts and uncertainties about what tax treaty override exactly is and when tax treaty override exactly occurs. However, as already emphasized above, given the limited elaboration about tax treaty override, the described positions are very valuable for this study and represent its starting point.

## 2. Methodology

### *2.1 Three different methodological phases in order to address a systematic analysis about tax treaty override*

This study addresses for the first time a legal systematization of tax treaty override. This necessarily has a major impact on the methodology that is to be applied. This methodology is characterized by three different phases which correspond to the three different stages of this study.

First of all, a clear understanding of the nature and origin of tax treaty override is necessary. The issue will be addressed under general international law. This first phase will, therefore, be characterized by its deductive methodology. The theories of Lauterpacht and Tanzi will be applied in order to establish whether states are allowed under international law to transform international law into national law and subsequently to apply the rule *lex posterior abrogat priori* so that a tax treaty is – in fact – unilaterally modified.

The answer to this question will be the starting point of an analysis which will develop an interpretative process aimed at individuating cases of tax treaty override. During the course of this analysis the definition of tax treaty override will gradually emerge. Exactly because this is the first attempt in literature to individuate all the necessary steps of an interpretative process aimed at detecting cases of tax treaty override, the methodological approach will necessarily be inductive. In the following paragraph 2.3 this inductive process will be described more in details. What is important to emphasize now is that this process will lead to the development of an ‘interpretative model’ applicable every time a case of treaty override needs to be identified. In the third methodological phase the developed ‘interpretative model’ will be tested on the basis of specific national regimes

### *2.2 The deductive phase: possible limits to state sovereignty*

The first paragraph concerning the purpose of this study has showed the necessity to elaborate a systematic analysis about tax treaty override in order to define the

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2006, p. 20; Malanczuk, P., *Akehurst's Modern Introduction to International Law*, Routledge, Seventh Revised Edition, 1997, p. 71.

many different aspects which are still uncertain about both the definition of tax treaty override and the interpretative process underlying its identification. However, one point is clear: tax treaty override stems from a conflict between laws.

This conflict depends on the relationship between national and international law. More specifically, tax treaty override depends on the fact that states regulate the relationship between international and national law at discretion<sup>26</sup>. Indeed, international law does not derive from a representative organ, like a national parliament and the jurisdiction of international tribunals is consensual<sup>27</sup>. Concretely, states have the possibility to decide what effect is to be attributed to international law within their territory.

In fact, some states apply international law automatically and directly, whereas other states subordinate the implementation of international law to its transformation and incorporation into national law. In the first case, treaty override is not admitted because international law prevails over national law. In the second case, treaty override is considered legitimate exactly because international law is transformed and incorporated into national law. Consequently, the rule *lex posterior abrogat priori* applies. This means that the law incorporating the international treaty can be amended by a subsequent national law that has the same rank within the national hierarchy of law. From a strict national point of view this ‘mechanism’ is absolutely legitimate. States can transform international law and incorporate it into national law. At the same time, the rule *lex posterior abrogat priori* is a common applied interpretative rule. However, this ‘mechanism’ based on the incorporation of international law into national law and the subsequent application of the rule *lex posterior abrogat priori* determines the unilateral amendment of a previously concluded international agreement. It determines a treaty override. Indeed, this process is the manifestation of the reluctance of states to abandon a certain deeply rooted conception of state sovereignty. As a consequence, Cassese emphasized the conviction of states that “the translation of international commands into domestic legal standards is part and parcel of their sovereignty”<sup>28</sup>. This is a crucial point of this study. Can still be accepted a notion of state sovereignty which allows states to unilaterally re-extend their rights after the conclusion of a valid international treaty ?

In order to give an answer to this question the theories of Lauterpacht and Tanzi will be applied in a deductive way: on the basis of a certain conception about the origin and nature of international law a solution will be given to the problem concerning the binding effects of a valid international agreement upon state sovereignty. Given the emphasized different position between those states

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<sup>26</sup> This will be demonstrated in the second chapter of this work where a country analysis is addressed.

<sup>27</sup> Participation is based on consent.

<sup>28</sup> Cassese, A., *International Law*, Oxford University Press, second edition, 2005, p. 220.

that confer automatic and direct effect to international law and those states that require its transformation into national law, the problem becomes whether the effect of international law depends on its constitutional systematization by each individual state (and, therefore, on the will of states) or, on the contrary, whether international law is objectively binding upon states. If the objectively binding nature of international law is recognized, a valid international agreement limits state sovereignty so that no posterior unilateral amendment can be considered legitimate regardless of the will of states. In addition, if the objectively binding nature of international law is recognized, the illegitimacy of treaty override does not stem from the violation of the rule *pacta sunt servanda* (as a rule of customary law or as a provision of the Vienna Convention on the Law of Treaties) but from the breach of the agreement in itself.

To conclude on this point, it is important to highlight that the immense richness of studies conducted on this topic in general international law has necessarily imposed a choice about the theories applicable to this study. This choice has been based on my conviction, which is also at the basis of the position of Lauterpacht and Tanzi, that inevitable starting point of a study about the nature of international law and its relationship with national law is the existence of an international community originally created by states. This aspect will be extensively explained in the second chapter.

### *2.3 The inductive phase: how to develop an interpretative process on which the identification of tax treaty override can be based? The notion of tax treaty override*

The second part of this study focuses on the development of an interpretative process aimed at detecting cases of tax treaty override. This interpretative process will take into consideration all the constituent elements of a tax treaty override. In parallel, a definition of tax treaty override will emerge and all its constituent elements will become clear. As already explained, the inductive character of this second phase of the analysis is the necessary consequence of the inexistence of a similar study and, therefore, of a model that could be deductively applied.

First of all, the peculiar structure and functioning of the OECD Model Convention will be analyzed.

There is a close and almost inextricable interrelation between treaty provisions and domestic tax law. This interrelation has been defined symbiotic by Jeffery<sup>29</sup>. This is because taxation is regulated by domestic substantive rules while their application is limited by the relevant treaty relieving provisions.

Double tax conventions – with a few exceptions – do not contain substantive provisions. They are mostly constituted by so-called distributive rules which –

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<sup>29</sup> Jeffery, R. J., *The Impact of State Sovereignty on Global Trade and International Taxation*, Series on International Taxation (No 23), Kluwer Law International, 1999, p. 104.

exactly – limit the domestic taxing power. In order to establish to what extent a tax treaty limits the domestic taxing power of a contracting state the exact relationship between domestic law and the specifically applicable distributive rule needs to be established. To this purpose, Vogel's model of distributive rule will be examined and applied in this study.

Once clarified the structure and functioning of the OECD Model Convention, as well as the relationship between treaty relieving provisions and domestic tax law, treaty interpretative rules need to be analyzed.

First of all, the general interpretative clause contained in the OECD Model Convention, i.e. art. 3(2), will be examined. This provision has a wide scope since it mandatorily applies every time the relevant treaty uses a term which is not defined within its text. In fact, tax treaties based on the OECD Model Convention use numerous undefined terms.

The interpretation of art. 3(2) requires to define its relationship with the interpretative provisions contained in the Vienna Convention on the Law of Treaties.

At the same time, the need to define the notion of context within the provision 'unless the context otherwise requires' under art. 3(2) determines the need to define the status of the OECD Commentaries and, specifically, the possibility that they are considered 'context' for tax treaty purposes.

The results of this theoretical analysis about art. 3(2) of the OECD Model Convention will be concretely analyzed through the examination of case law specifically dealing with the application of the provision at issue. In addition, this case law will give us the possibility to examine the application of art. 3(2) in connection with fictitious income definitions. Subsequently, case law about exit taxation will be examined. This case law will give us the possibility to deeper understand the application of art. 3(2) in connection with fictitious income/capital. In addition, the analysis will concern fictitious residence. It is extremely important to verify to what extent 'pure' fictitious tax residence (i.e. tax residence which is not based on any nexus with the state concerned but a 'legal fiction') is acceptable under the OECD Model Convention.

Finally, the possibility to justify tax treaty override will be analyzed. In particular, the relationship between domestic anti-abuse provisions and treaty provisions will be examined in order to establish whether, under the OECD Model Convention, a *de facto* unilateral amendment of a tax treaty is admissible in order to curb tax avoidance or evasion.

At this point all the relevant elements to detect possible cases of tax treaty override will have been taken into consideration. The definition of tax treaty override will be clear in all its constituent elements and an interpretative model to detect cases of tax treaty override will have been developed.

## 2.4 *The third phase: the application of the ‘interpretative model’*

The third phase of this research has a more practical character. The efficacy and practicability of the developed ‘interpretative model’ will be tested. First of all, this ‘interpretative model’ will be applied to the newly introduced U.S. exit tax regime. In 2008 for the first time the United States introduced a ‘genuine’ exit tax regime after having applied for decades an ‘expatriation tax’. Under the expatriation tax, U.S. citizens or long-term residents who left the U.S. were taxed for the ten years following the year of expatriation on U.S. sourced items of income and capital as re-characterized under the Internal Revenue Code<sup>30</sup>. The application of the expatriation tax has been based on the introduction within the tax treaties concluded by the United States of a saving clause that allowed taxation of previous citizens and long-term residents. Since the new exit tax regime is based on the deemed alienation of all properties owned by an individual just before emigration (which means that the exit tax regime is based on the fictitious tax residence in the U.S. at the moment of alienation), it is interesting to evaluate whether this new exit tax regime is covered by the saving clause or, on the contrary, whether it has realized cases of tax treaty override. The developed ‘interpretative model’ will subsequently be applied to the UK ‘re-entry charge’. The United Kingdom has no exit tax. It applies a so-called ‘re-entry charge’ to taxpayers that transfer their residence abroad for less than five years. In this case, capital gains which were realized during the period of residence abroad but on assets already owned when the taxpayer was resident or ordinarily resident in the UK, are deemed to arise only at the moment when the taxpayer becomes resident of the UK again. This is a really peculiar regime since capital gains are taxed when they are actually realized. However, taxation does not take place in the state of residence at the moment of alienation according to art. 13(5) of the OECD Model Convention. The UK system extends the tax liability of the taxpayer. Capital gains are deemed to have been realized in the UK in the year when the taxpayer comes back to the United Kingdom. In fact, this fiction extends the tax liability of the taxpayer so that he or she can be taxed in the UK. Can this fiction be considered compliant with the OECD Model Convention or, on the contrary, has it realized cases of tax treaty override? The developed ‘interpretative model’ will make it able to answer this question.

Finally, the so-called ‘transactional approach’ which characterizes a few national CFC regimes will be tested on the basis of the ‘interpretative model’. Chapter V of this study will analyze the relationship between CFC regimes based on a so-called ‘entity approach’ in order to confute the position of the OECD according to which CFC legislation does not affect tax treaties based on the OECD Model

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<sup>30</sup> These are the main features of the expatriation regime as amended in 1996. This was the most enduring U.S. expatriation regime. It was modified in 2004, but the amendments did not concerned the described main functioning.

Convention. The so-called ‘entity approach’ is mainly based on the allocation of the controlled foreign corporation without any distinction concerning the taxable income. On the contrary, the so-called ‘transactional approach’ covers only specific items of income, mostly passive income. The interpretative model will be applied in order to verify the compliance of this transactional approach with the OECD Model Convention. However, this analysis presupposes an evaluation about the applicable distributive rules. Also in this case the ‘interpretative model’ will be decisive.

### 3. Research questions

This study will address two research questions:

- a) *‘Is an international agreement binding upon states so that their sovereignty is effectively limited and, as a consequence, states are not allowed to transform and incorporate international law into national law and subsequently apply the rule *lex posterior abrogat priori* when the result is that a treaty override is - in fact – realized ?’*
- b) *‘How to develop an ‘interpretative model’ which covers all the possible cases of tax treaty override ?’* The research concerning this question will imply the individuation of the constituent elements that define a tax treaty override.

#### 3.1 Sub-questions

The previous paragraphs of this chapter have made clear the development that this study will follow.

The first sub-question that this study needs to answer is: *‘Are states allowed to regulate at discretion the effects of international law within their national legal system ?’*

As already explained above, the answer to this question depends on the nature of international law. Only if international law is considered objectively binding its effect within national legal systems cannot depend on the will of states. The second sub-question is therefore: *‘Can international law be considered objectively binding upon states ?’*

Subsequently, the following sub-question will be addressed: *‘Is tax treaty override a violation of international law?’*

If tax treaty override is considered to be a violation of international law, the following sub-questions will be addressed: *‘Does tax treaty override give rise to state responsibility under the ‘Draft Articles on State Responsibility’ ?’; ‘Does legislative tax treaty override, as a legal injury, give rise to state responsibility under the ‘Draft Articles on State Responsibility’ ?’*

Once defined these problems, the analysis will mainly focus on the elaboration of an interpretative process aimed at exactly understanding the relationship existing between tax treaty provisions (on the basis of the OECD Model Convention) and domestic law. If in the first part of this study it is ascertained that international law is binding upon states and, therefore, a valid international agreement limits state sovereignty, the following sub-question will be dealt with: *‘How to define exactly the relationship existing between a tax treaty provision and national law in order to establish to what extent a concluded international agreement has limited the contracting state sovereignty?’*.

#### **4. Structure of the work**

This study consists of seven chapters, including this introduction and the conclusions.

- 1) Chapter I essentially has the function of explaining the core of this study by emphasizing why a systematic research on tax treaty override is currently important, the methodology underlying this research and the main problems that this research will address.
- 2) Chapter II is a deep analysis of the origin and nature of tax treaty override from a general international law perspective. The core of this chapter is represented by the study concerning the nature of international law and its effects on state sovereignty. The main characteristics of the international community will be analyzed with a focus on the role of states as ‘creators’ of international law through their consent and ‘recognition’. States’ consent and ‘recognition’ are also at the origin of the principle of sovereign equality which is one of the pillars of the international community. The principle of sovereign equality underlies the conclusion of international agreements and guarantees an equal position between the parties to it.  
As corollaries of the principle of sovereign equality, good faith, legitimate expectations and reciprocity have a central role when tax treaty override is investigated
- 3) In chapter III the specific analysis concerning tax treaty override starts on the basis of the results of the previous chapter about the nature of international law and its impact on state sovereignty. Chapter III aims at giving a deep understanding of the structure and functioning of the OECD Model Convention. The close interrelation between treaty provisions and domestic law is highlighted. A clear insight of this interrelation is essential in order to establish to what extent treaty provisions have limited the sovereignty – i.e. taxing power – of the contracting states.



- 4) Chapter IV is divided into two parts: part A and part B. The first part deals with the interpretation of art. 3(2) of the OECD Model Convention. As a general interpretative clause it has a central role in the application of tax treaties based on the OECD Model Convention. Its relationship with the interpretative provisions of the Vienna Convention will be established. In order to verify whether a case of tax treaty override has occurred under art. 3(2), the interpretation of the sentence – ‘unless the context otherwise requires’ – is fundamental. This analysis will also necessarily involve an examination about the notion of ‘context’ and consequently about the possibility to include the OECD Commentaries within a tax treaty context. At the end of part A the compliance of fictitious definitions with tax treaties based on the OECD Model Convention will be analyzed under art. 3(2). Part B of this chapter will continue the examination of the relationship between fictions and the OECD Model Convention through the analysis of case law concerning exit taxation (again on the basis of art. 3(2) of the OECD Model Convention).
- 5) In chapter V the relationship between domestic anti-abuse rules (including judicial doctrines) and treaty provisions will be addressed. Purpose of this chapter is to verify whether, according to the OECD Model Convention and its Commentaries, the purpose of curbing tax avoidance or tax evasion and, in general, the abuse of a tax treaty can represent a justification for tax treaty override. This question requires to establish whether the OECD Model and its Commentaries give priority to safeguarding the contracting states tax base or to the application of the relevant treaty in order to avoid double taxation. This issue needs to be solved through the analysis of the OECD Commentary to art. 1 of the Model. Therefore, this chapter will first focus on the OECD’s approach concerning in general the relationship between anti-abuse provisions and treaty provisions. Subsequently, the OECD’s position about CFC legislation will be addressed. This position will be confronted with the most relevant case law as well as the most relevant literature showing the different positions about the extent to which tax treaty provisions affect CFC and, in general, domestic anti-abuse legislation.
- 6) In chapter VI the developed ‘interpretative model’ will be illustrated and applied to the new U.S. exit tax regime, to the Dutch exit tax regime applied upon company’s emigration, to the UK ‘re-entry charge’ and to CFC regimes based on the so-called ‘transactional approach’.
- 7) Chapter VII will provide an overview of the conclusions of this study. The research questions and sub-questions will be specifically answered and the exhaustiveness and efficacy of the developed ‘interpretative model’ will be showed and commented.

## 5. Acknowledgements

The purpose of this study which, in general terms, concerns a legal systematization of tax treaty override has imposed some choices. A legal systematization of a certain topic cannot start but from its origin and nature. Therefore, I considered it extremely important first of all to understand the origin and nature of tax treaty override. This has run me into an exciting study about general international law that – I must admit – was not easy considering my specialization as tax lawyer. I hope that the reader will appreciate the effort aimed at a deep understanding of tax treaty override in its natural context, i.e. general international law. The decision to give a deep insight about the foundation of tax treaty override has led to exclude from this study a part specifically dedicated to tax treaty override within a EU context. However, in the *Columbus Container*<sup>31</sup> and *Damseaux*<sup>32</sup> cases the Court of the European Union has – agreeably – stated that it has no competence about the relationship between national and international law. Treaty override can be only indirectly relevant when it results to be a violation of EU law.

At the same time, the choice about the legal regimes that will be analyzed has been determined by the necessity of examining all the constituent elements of a tax treaty override. The legal regimes that permit to highlight these elements have been chosen. The purpose is to develop an ‘interpretative model’ with a broad scope and capable to be applied every time a possible case of treaty override needs to be analyzed.

Finally, I would like to emphasize that this research is the result of a co-directed PhD based on an agreement between the University of Bologna and Tilburg University. From a practical point of view this has involved that the research has been conducted alternatively in Italy and in the Netherlands with two supervisors of different nationality. I hope that the spirit of this experience is apparent in my research and that I was able to make this study the synthesis of two different but equally rich cultures. Both of them have had a big impact on the content, methodology and structure of this study.

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<sup>31</sup> ECJ 6 December 2007, C-298/05 *Columbus Container Services*, ECR 2007 p. I-10451, par. 46 – 47.

<sup>32</sup> ECJ 16 July 2009, C-128/08 *Damseaux*, ECR 2009 p. I-6823, par. 22.



## Chapter II

### *Nature and origin of tax treaty override*

#### **1. Introduction: tax treaty override and international law**

Purpose of this second chapter is to analyze and understand tax treaty override from a general international law point of view. In order to characterize tax treaty override and deeply understand its peculiarities the evaluation of the effects of general international law on tax treaties based on the OECD Model Convention is a necessary pre-condition.

This need stems from the peculiar structure and functioning of the OECD Model Convention. Exactly its characteristics require to evaluate the impact of general international law on the application of tax treaties within national legal systems.

The structure of the OECD Model Convention is such as to create an almost inextricable interrelation between treaty provisions and national law. Jeffery has defined this interrelation symbiotic<sup>1</sup> to emphasize how difficult it can be to distinguish between those prerogatives that – even after the conclusion of a tax treaty – still fall within a state tax jurisdiction and those aspects of a state taxing power that have been limited and, therefore, do not fall within national sovereignty any longer. This is because the functioning of tax treaties is essentially based on so-called ‘distributive rules’ which – in short – individuate the state that has the right to tax while taxation remains based on the national law of each contracting party.

There is, therefore, a division between substantive tax law, which applies under national legislation, and distributive rules, which are formal rules limiting each contracting state tax sovereignty and, therefore, the application of substantive national law.

The tension is, thus, constant between the formal rules that limit tax jurisdiction and national substantive tax provisions.

To what extent can a state unilaterally amend domestic tax legislation without exceeding the limits established by each distributive rule? This question presupposes an analysis of the relationship between national and international law and, therefore, primary and essentially an examination of their own effects. The first issue that needs to be dealt with is the contrast between the objective nature of an analysis concerning the effects of law and the fact that each state

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<sup>1</sup> Jeffery, R. J., *The Impact of State Sovereignty on Global Trade and International Taxation*, Series on International Taxation (No 23), Kluwer Law International, 1999, p. 104.

regulates differently the relationship between national and international law so that the attribution of their effects assumes a subjective nature.

As a consequence of this different regulation of the relationship between national and international law, treaty override is actually realized by many states that have developed their own doctrines about the domestic validity of tax treaty override. One could – in fact – wonder if the practice that domestically allows tax treaty override could in itself be considered sufficient in order to establish its admissibility at the international level as well.

There is a relatively new pragmatic stance<sup>2</sup> among international lawyers according to which any theory about the relationship between international and national law should be set aside and substituted by an empirical analysis of the actual behavior of states. As a result, national practice becomes the evidence of what should be considered legitimate (or at least accepted) at the international level.

Clearly, this pragmatic approach makes any evaluation about possible breaches of international law limited to a domestic perspective. The result is – paradoxically – the impossibility to evaluate from an international point of view a possible breach of international law.

The mere fact that tax treaty override is realized by some states would make it admissible.

This position – in fact – exacerbates states practice so that Nijman and Nollkaemper stimulate to reflect: *‘Does the fact that states retain their competence under their national law to enact laws inconsistent with their international obligations mean that we have to accept an international legal liberty to do so?’*<sup>3</sup>

Generally speaking, in those states where treaty override is allowed international law is incorporated and ‘transformed’ into national law. Consequently, international law is equated to domestic law and considered amendable through a subsequent national provision that has the same rank within the national hierarchy (*lex posterior abrogat priori*).

It is worth noting that states which admit tax treaty override do not claim a discretionary right to amend international treaties. These states do not deny the binding effects of international agreements. However, at the same time they assert their right to implement international law through its transformation into national law. The possibility to amend an international treaty is a consequence deriving from transformation of international law into national law.

At the basis of tax treaty override, as indeed is the case for international law in general, there is a strong tension between power and law. Tax treaty override is a form of unilateralism that is actually based on the contractual power of a state. This is proved by the fact that tax treaty override occurs in some of the politically and economically strongest countries, i.e. United States and Germany.

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<sup>2</sup> See paragraph 2 below in this chapter.

<sup>3</sup> Nijman, J. and Nollkaemper, A., *Introduction*, in Nijman, J. and Nollkaemper, A. (editors), *New Perspectives on the Divide Between National & International Law*, Oxford University Press, 2007, p. 3.

Undoubtedly, international law is strongly governed by state interests. And when these interests cannot be realized in accordance with international law, the typical reaction of states is unilateralism based on the assertion of national principles of law. The justification for this attitude is generally the need to protect superior aims and values.

In an extremely critical moment, when at the beginning of the 2000's the United States needed to legitimate their intervention policy in Iraq, which the Secretary-General of the United Nations had clearly defined 'illegal' on the basis of the UN Charter<sup>4</sup>, the United States' reaction was a severe unilateralism essentially based on self-legitimation.

During a public speech the U.S. Under Secretary of State for Arms Control and International Security stated:

*'Our actions, taken consistently with constitutional principles, require no separate external validation to make them legitimate. Whether it is removing a rogue Iraqi regime and replacing it, preventing weapons of mass destruction proliferation, or protecting America against an unaccountable court, the United States will utilize institution of representative government, adhere to its constitutional structures, and follow its values when measuring the legitimacy of its action.'*<sup>5</sup>

The line of reasoning remains the same when, with specific reference to tax treaty overrides enacted in the U.S. in the course of the 1980's (and, therefore, in an absolutely less dramatic international situation), a former chief of staff of the Joint Committee on Taxation, stated:

*'I think that basically the congressional view point on this, at least insofar as I've been able to participate in this exercises, is that the general principles of good tax policy domestically ought to be extended into the international area and used as the foundation of tax treaty policy'.*

*'Our problem on the Hill was basically that we had some strongly held views about what was good policy. When we saw that the rate of change in the treaty program was glacial and that there were some minor errors where they did not have the ability to change, we felt that some action was necessary and I think we've done it.'*<sup>6</sup>

It is interesting to note that attempts to legitimate states unilateralism seem to echo the need of justifying an attitude which is not (completely) accepted by the international community<sup>7</sup>.

<sup>4</sup> Blix, H., *The Use of Force in the International Community*, Hersch Lauterpacht Memorial Lectures, Lauterpacht Centre for International Law, 2004, at [http://www.lcil.cam.ac.uk/lectures/2004\\_dr\\_hans\\_blix.php](http://www.lcil.cam.ac.uk/lectures/2004_dr_hans_blix.php), (PDF format) p. 5.

<sup>5</sup> Bolton, J., Address Before the Federalist Society at the 2003 National Lawyers Convention, at [http://www.fed-soc.org/doclib/20070324\\_bolton.pdf](http://www.fed-soc.org/doclib/20070324_bolton.pdf), p. 7.

<sup>6</sup> As reported by Sachs, D., *Is the 19<sup>th</sup> Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, in *Tax Lawyer*, Volume 47 (1993- 1994), No. 4, pp. 876 – 877.

<sup>7</sup> Avi-Yonah, R. S., *Tax Treaty Overrides: A qualified Defence of U.S. Practice*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 65 – 80; McIntyre, M., *A Defense of Treaty Overrides* (Editor's Notebook), in *Tax Notes International*, Vol. 1 (1989), No. 6, pp. 611 – 614.

Moreover, as already emphasized, states do not deny the binding effects of an international agreement. In order to justify its breach states distort the original scope of the rule *lex posterior abrogat priori*.

In fact, the application of the rule in this context presupposes the paradoxical mechanism according to which an international agreement becomes a national law.

Transformation of an international treaty into a domestic law means that a bilateral or multilateral act assumes the form of a national unilateral act. A previous unilateral act can be, indeed, amended by a subsequent unilateral act.

However, an international treaty, although incorporated into a unilateral national law, remains an international agreement under international law. It is an agreement which has limited the sovereignty of its parties internationally.

Thus, starting point of an examination concerning tax treaty override is not, and cannot, be national practice, but the conclusion of a valid agreement which, on the basis of the consent of its contracting parties, has determined a limitation of their sovereignty by constituting a certain relationship between its international provisions and domestic law.

The application of the rule *lex posterior abrogat priori* cannot be considered legitimate when it determines a unilateral re-extension of state sovereignty which was limited by the conclusion of a valid international treaty. The opposite view presupposes an absolute<sup>8</sup> conception of state sovereignty that is not conform to the present status of the international community. This is, instead, founded on sovereign equality<sup>9</sup>.

International law is here conceived as having an ‘*aspirational dimension ... beyond [its] prescriptive function*’<sup>10</sup>.

International law pursues some values and interests that are the values and interests generally recognized, i.e. mutually accepted, by the majority of states.

This functional dimension of international law is, indeed, fundamental and disregarding it in the interpretation process about the compliance of national law with international law would mean to deprive the international legal system of its own essence.

Paradigmatic for this work is Tanzi’s position according to which: ‘a) ‘*Law*’ made of rules and structural arrangements is the result of a social and political process, which is part and parcel of the legal process; b) such processes are, in their turn, affected by the aspirational dimension of legal rules, beyond their purported prescriptive function; c) therefore, legal rules may make up a myth system which reflects values and sets standards that are diffusely perceived as valid and variably taken into account by social actors in their

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<sup>8</sup> Jackson, J. H., *Sovereignty-modern: A New Approach to an Outdated Concept*, in Walker, N. (editor), *Relocating Sovereignty*, The International Library of Essays in Law & Legal Theory, Second Series, Dartmouth Publishing Company, 2006, pp. 425 – 445.

<sup>9</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 150.

<sup>10</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 146.

*behavioural choices and in social judgments, even when they are infringed upon; d) legal rules are relative according to the standpoint from which they are viewed and, eventually, interpreted and applied; e) the perception by the relevant social actors as to whether a given legal or structural arrangement, or operational code, still reflects the common interest, or their own interest, is part of the social dynamic that makes up the legal process characterized by legislative tension between stability and change.*<sup>11</sup>

The international community reflects interests and values of its own actors and mostly of states. It is, therefore, characterized by a continuous tension between change and maintenance of the *status quo*. Changes are important to guarantee evolution of international law and protection of new shared interests<sup>12</sup>.

However, the *Law*, in its aspirational function, must guarantee the protection of interests and values that at each specific historical moment are common to the majority of the members of the international community and, therefore, are the fundamentals of this community. *Law* should, therefore, work as a limit to unilateralism to guarantee the prevalence of shared interests and values within the international community.

## **2. The need to have a preliminary concrete look at the relationship between international and national law**

Traditionally, the relationship between international and national law has been explained on the basis of the monist or dualist (pluralist<sup>13</sup>) theories. In essential lines, the different conception of this relationship on which the two schools of thought are based determines the necessity of transforming international law into municipal law or simply adopting international law within the national legal system.

Monism considers national and international legal orders as two parts of a single legal system. Therefore, from a monist point of view, as soon as international law becomes valid, it is automatically considered valid within the national legal order as well.

In contrast, the dualist theory considers international and national legal orders to be two distinct and self-contained legal systems. Consequently, a valid

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<sup>11</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 146.

<sup>12</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, pp. 146 – 147.

<sup>13</sup> About the reason why dualists prefer to use the word ‘pluralism’, see Arangio-Ruiz, G., *International Law and Interindividual Law*, in Nijman, J. and Nollkaemper, A. (editors), *New Perspectives on the Divide Between National & International Law*, Oxford University Press, 2007, p. 17; Gaja, G., *Dualism – a Review*, in J. Nijman and A. Nollkaemper (editors), *New Perspectives on the Divide Between national & International Law*, Oxford University Press, 2007, p. 53.



international law needs to be transformed into a valid national law in order to be considered applicable within the national legal system. *‘The dualist view, in other words, is that the key to the implementation of international law within the framework of national law is in the hands of national law itself, as impersonated by the constituent, the legislator, or the courts, in the exercise of powers they respectively derive from national law, and (except for natural law, morality, or ethics) just from that law.’*<sup>14</sup>

More recently, many scholars have taken the position that monist and dualist conceptions are an over-simplification of the complex problem concerning the effect of international law within domestic legal systems<sup>15</sup>. They are considered theoretical models that do not correspond to practice.

Ruda wrote: *‘... the modern tendency is to analyse the concrete conclusions derived from legislation, preferably constitutional in nature, and case law, bearing on the question of the relation between international and municipal law. In fact there is even a tendency, nowadays, to exclude from general works a detailed analysis of the various theories.’*<sup>16</sup>

Vereshchetin pointed out: *‘The fact that monist and dualist concepts were advanced and elaborated mainly on a speculative basis, in the absence of any solid constitutional practice, which could prove or disprove them, and in an absolutely different international setting, deprives these concepts of a guiding role in modern constitution-making. The legislator, instead of taking sides in the endless and sterile doctrinal debate, should rely and is, in fact, increasingly relying, on a proper understanding of the national interests in conformity with the exigencies of contemporary international life.’*<sup>17</sup>

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<sup>14</sup> Arangio-Ruiz, G. *International Law and Interindividual Law*, in Nijman, J. and Nollkaemper, A. (editors), *New Perspectives on the Divide Between National & International Law*, Oxford University Press, 2007, p. 19.

<sup>15</sup> Jacobs, F., Introduction, in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, p. XXIV; Denza, E., *The Relationship between International and National Law*, in Evans, M. D. (editor) *International Law*, Oxford University Press 2006, p. 429; Vereshchetin, H. E. V. S., *Some Reflections on the Relationship Between International Law and National Law in the light of New Constitutions*, in *Constitutional Reform and International Law in Central and Eastern Europe*, edited by Müllerson, R., Fitzmaurice, M. and Andrenas, M., Kluwer Law International, 1998, p. 6; Partsch, K. J., *‘International law and municipal law’*, in Bernhardt, R. (editor), *Encyclopedia of Public International Law*, Amsterdam North -Holland, vol. II, 1995, p. 1184.

<sup>16</sup> Ruda, J. M., *The Relationship Between International and National Law*, in *Thesaurus Acroasium*, Vol. XXI “East –West Relations (Legal, Economic, Political, etc. Aspects)”. Institute of International Public Law and International Relations of Thessaloniki, 1994, p. 328.

<sup>17</sup> Vereshchetin, H. E. V. S., *Some Reflections on the Relationship Between International Law and National Law in the light of New Constitutions*, in *Constitutional Reform and International Law in Central and Eastern Europe*, edited by Müllerson, R., Fitzmaurice, M. and Andrenas, M., Kluwer Law International, 1998, pp. 6 -7.

Finally, Fitzmaurice was even more direct: ‘*The entire monist-dualist controversy is unreal, artificial and strictly beside the point ...*’<sup>18</sup>

However, as emphasized in the introduction of the present chapter, this position, which is exclusively based on the observation of states’ practice, excludes any functional evaluation of law.

Certainly, a clear understanding of the problems at issue is necessary and it requires a concrete look at the relationship between international and municipal law. The following paragraphs will analyze this relationship in four countries with different constitutional systems. This analysis has mainly the purpose of understanding how international law actually applies within national legal systems and in what way national legislation or case law allows or disallows tax treaty override. This analysis mostly aims at illustrating how states conceive tax treaty override and what is its legal and/or judicial foundation. It will show that, although the traditional qualification as monist or dualist states may be obsolete, in fact, the legislation of some states requires transformation of international law into national law while other states directly apply international law. Those states that transform international law into national law usually consider tax treaty override legitimate under the rule *lex posterior abrogat priori*.

Nevertheless – and this is the fundamental position taken in this chapter – observation of states practice cannot statically preclude an examination about the existence of possible legal prescriptions as binding parameters to evaluate the legitimacy of states’ practice and specifically the application of the rule *lex posterior abrogat priori*.

In the introduction of this chapter the contrast between the objective nature of an analysis concerning the effects of law and the fact that each state regulates differently the relationship between national and international law so that the attribution of their effects assumes a subjective nature has been pointed out.

The following country analysis will show the subjective approach of states with regard to the relationship between national and international law. Each state recognizes different effects to international law within its own jurisdiction. However, this will only be the starting point to arrive at demonstrating the objectively binding nature of international law, regardless of its way of implementation within national systems.

The choice about the four countries analyzed in this chapter has been made with the main purpose of showing the variety of constitutional systems. The firm position of the United States in favour of treaty override is in sharp contrast with the position of the Netherlands that recognizes the prevalence of international law even over constitutional provisions. The doctrine elaborated in the United States in favour of treaty override is quite peculiar, mostly because it is based on a Supremacy Clause that directly qualifies international treaties as federal law. Italy has implemented an important constitutional reform in 2001.

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<sup>18</sup> Fitzmaurice, G., *The General Principles of International Law Considered from the Standpoint of the Rule of Law*, in 92 *Recueil des Cours* (1957-II), p. 71.

Consequently, its position in favour of treaty override has been changed, and now international treaty obligations prevail over domestic law notwithstanding international law is transformed into national law. Germany largely admits treaty override, although a new position of the Federal Tax Court seems to accept a different interpretation of the Constitution in order to recognize priority to international law over national law.

### 2.1. *The U.S. treaty override doctrine*<sup>19</sup>

The United States position about the relationship between national law and international treaties is strongly in favour of treaty override. This position is based on the treaty override doctrine which was elaborated by the Supreme Court already in the late nineteenth century.

Technically, this doctrine is based on two provisions of the U.S. Constitution. Art. VI, § 2 contains a Supremacy Clause according to which ‘*This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under the Authority of the United States, shall be Supreme Law of the Land ...*’

Moreover, art. II<sup>20</sup>, § 2, cl. 2 states : ‘*He [the President] shall have Power, by and with the Advice and Consent of the Senate to make Treaties, provided two thirds of the Senators present concur ...*’

There are, therefore, two aspects that need to be taken into consideration. First of all international treaties and domestic law have the same rank within the national hierarchy. Both of them are Supreme Law of the Land (i.e. federal legislation) and no priority is given to one or another by the U.S. Constitution.

Furthermore, the adoption and ratification procedure of an international treaty does not involve the House of Representatives. A treaty is approved by the Senate and subsequently ratified by the President.

These are the main constitutional pillars on which the Supreme Court has based its doctrine allowing treaty override in the United States.

This doctrine, indeed, presupposes and is supported by a conform interpretation about the nature of international treaties.

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<sup>19</sup> It is important to recall that the United States has signed but not yet ratified the Vienna Convention on the Law of Treaties. However, the United States shares the common position according to which most of the provisions of the Vienna Convention have codified customary law. See Infanti, A. C., *United States*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 360 (footnote No. 22). For additional literature about the nature of customary law of many provisions contained within the Vienna Convention on the Law of Treaties, see *infra* chapter IV footnote No 23.

<sup>20</sup> Article II of the US Constitution establishes the powers of the President of the United States.

Thus, in the *Foster v. Neilson* case, which did not concern treaty override, the Supreme Court held: ‘A treaty is in its nature a contract between two nations, not a legislative act.

... In the United States a different principle is established. Our Constitution declares a treaty to be the law of the land. It is, consequently, to be regarded in courts of justice as equivalent to an act of the legislature, whenever it operates of itself without the aid of any legislative provision.’<sup>21</sup>

In the U.S. there is, therefore, no transformation of international law into national law. The Constitution directly confers international treaties the form of ‘law’. Only non self-executing treaties require implementation.

This approach, which has been consistently maintained by the Supreme Court<sup>22 23</sup>, can actually be seen as the necessary premise to a position that needs to justify how a unilateral act can amend a bilateral or multilateral act (which is the paradoxical structure of a treaty override).

Given this premise, the main argument on which the U.S. doctrine on treaty override is based concerns the Supremacy Clause and specifically the fact that the U.S. Constitution does not establish any priority between international treaty provisions and national statutes since both are (unilateral) Law of the Land. On this basis the U.S. Supreme Court has affirmed the ‘later in time’ rule. A later unilateral federal statute can amend a previous international treaty which, according to the interpretation of the Constitution given by the Supreme Court, is equivalent to a unilateral act. ‘By the Constitution a treaty is placed on the same footing, and made of like obligation, with an act of legislation. Both are declared by that instrument to be the supreme law of the land, and no superior efficacy is given to either over the other.’<sup>24</sup> ‘The duty of the courts is to construe and give effect to the latest expression of the sovereign will.’<sup>25</sup>

In addition, ‘An Act of Congress, which must comply with the Constitution, is on full parity with a treaty, and ... when a statute which is subsequent in time is inconsistent with a treaty, the statute to the extent of conflict renders the treaty null.’<sup>26</sup>

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<sup>21</sup> *Foster v. Neilson*, 27 U.S. (2 Pet.) 253, 314 (1829).

<sup>22</sup> *The Chinese Exclusion Case*, 130 U.S. 581, 585 –86 (1889); *Whitney v. Robertson*, 124 U.S. 190, 193 –94 (1888); *The Head Money Cases*, 112 U.S. 580, 599 (1884)

<sup>23</sup> See also Infanti, A. C., United States, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 356.

<sup>24</sup> *Whitney v. Robertson*, 124 U.S. 190, 194 (1888). See Sachs, D., *Is the 19<sup>th</sup> Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, in *Tax Lawyer*, Volume 47 (1993– 1994), No. 4, p. 878.

<sup>25</sup> *Whitney v. Robertson*, 124 U.S. 190, 195 (1888). See Avi-Yonah, R. S., *Tax Treaty Overrides: A qualified Defence of U.S. Practice*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 69.

<sup>26</sup> *Reid v. Covert*, 354 U.S. 1, 18 (1957). See Avi-Yonah, R. S., *Tax Treaty Overrides: A qualified Defence of U.S. Practice*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 69.

The need to preserve state sovereignty was immediately pointed out by the Supreme Court. The *Cherokee Tobacco* case was the first one in which the Supreme Court ruled that an international treaty could be overridden by a subsequent federal statute<sup>27</sup>: ‘*The effect of treaties and acts of Congress, when in conflict, is not settled by the Constitution. But the question is not involved in any doubt as to its proper solution. A treaty may supersede a prior act of Congress, and an act of Congress may supersede a prior treaty.*’<sup>28</sup>

In the *Cherokee Tobacco* case the possibility that a federal statute overrides a previous international treaty was essentially argued on the basis of the reasoning underlying a trial court opinion, i.e. *Taylor v. Morton*<sup>29</sup>. The Supreme Court recalled the passage of the opinion according to which the compliance of domestic statutes with international treaties is a political matter. Therefore, judges have no competence.

In *Taylor v. Morton* it was specified that the possibility to amend a previous treaty is a prerogative of the Congress whose denial would deprive a state of its sovereignty.

This plea was consistently upheld by the Supreme Court.

In the *Chinese Exclusion* case was stated ‘[W]hilst it would always be a matter of utmost gravity and delicacy to refuse to execute a treaty, the power to do so was prerogative, of which no nation could be deprived without deeply affecting its independence ...’<sup>30</sup>

In *Botiller v. Dominguez* the Supreme Court maintained: ‘*This Court, in a class of cases like the present, has no power to set itself up as the instrumentality for enforcing the provisions of a treaty with a foreign nation which the United States, as a sovereign power, chooses to disregard*’<sup>31</sup>.

Another aspect concerning the U.S. doctrine on treaty override is that the House of Representatives is not involved in the treaty making process: ‘*A treaty is made by the President and the Senate. Statues are made by the President, the Senate and the House of Representatives. The addition of the latter body to the other two in making a law certainly does not render it less entitled to respect in the matter of its repeal or modification than a treaty made by the other two. If there is any difference in this regard, it would seem to be in favor of an act in which all three of the bodies participate*’.

On these grounds, as from 1962 a series of legislative tax treaty overrides has occurred in the United States.

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<sup>27</sup> Sachs, D., *Is the 19<sup>th</sup> Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, in *Tax Lawyer*, Volume 47 (1993– 1994), No. 4, p. 868.

<sup>28</sup> *The Cherokee Tobacco*, 78 U.S. (11 Wall.) 616 (1870).

<sup>29</sup> 23 F. Cas. 784 (C.C.D. Mass. 1855) (No 13.799) *aff’d on procedural grounds*, 67 U.S. (2 Black) 481 (1862).

<sup>30</sup> *The Chinese Exclusion* case, 130 U.S. 238, 247 (1889). See Sachs, D., *Is the 19<sup>th</sup> Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, in *Tax Lawyer*, Volume 47 (1993– 1994), No. 4, p. 878.

<sup>31</sup> *Botiller v. Dominguez*, 130 U.S. 190, 194 (1889). See Sachs, D., *Is the 19<sup>th</sup> Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, in *Tax Lawyer*, Volume 47 (1993– 1994), No. 4, p. 878.

It is important to highlight that, notwithstanding the clear position of the Supreme Court, the legislative approach in favour of treaty override was developed only gradually.

In fact, section 894 of the Internal Revenue Code – entitled ‘Income exempt under treaty’ – in 1954 established that *‘[i]ncome of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.’*<sup>32</sup>

Accordingly, section 7852(d) (‘Treaty obligations’) of the 1954 Code stated: ‘No provision of this title shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on the date of enactment of this title.’

Nevertheless, the scope of section 7852(d) was firstly limited with the Revenue Act of 1962<sup>33</sup>. Section 31 – ‘Treaties’ – of the Revenue Act of 1962 stated: ‘Section 7852(d) of the Internal Revenue Code of 1954 (relating to treaty obligations) shall not apply in respect of any amendment made by this Act’.<sup>34</sup>

It is worth noting that the Revenue Act of 1962 introduced the notorious subpart F legislation<sup>35</sup> which was proposed and strongly supported by the Kennedy Administration<sup>36</sup> and which is considered the starting application of the Capital Export Neutrality principle<sup>37</sup>.

In the following years treaty overrides were quite easily realized, although the overriding effects were limited to the specific new legislation. Since 1962 ‘Congress has with increasing frequency enacted legislation that is intended to override inconsistent provisions in existing (and, in some cases, even future) tax treaties. Indeed, nearly every major piece of tax legislation since the mid-1970s has contained at least one

<sup>32</sup> Cfr. Infanti, A. C., United States, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 366; Sachs, D., *Is the 19<sup>th</sup> Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, in Tax Lawyer, Volume 47 (1993– 1994), No. 4, p. 870.

<sup>33</sup> It is interesting to note that the Revenue Act 1962 was ratified by President John F. Kennedy on October 16, 1962.

<sup>34</sup> Sachs, D., *Is the 19<sup>th</sup> Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, in Tax Lawyer, Volume 47 (1993– 1994), No. 4, pp. 870– 871.

<sup>35</sup> Revenue Act of 1962, Section 12 – Controlled Foreign Corporations, p. 1006: ‘ (a) IN GENERAL – PART III of the Subchapter N of chapter 1 (relating to income from sources without the United States is amended by adding at the end thereof the following new subparts:

“Subpart F – Controlled Foreign Corporations” ’

<sup>36</sup> Lokken, L. *Whatever Happened to Subpart F ? U.S. CFC Legislation After the Check –the-Box Regulations*, in Florida Tax Review, Vol. 7 (2005 – 2006), No. 3, pp. 188 –189.

<sup>37</sup> Ayy-Yona, R. S., *All of a Piece Throughout: The Four Ages of U.S. International Taxation*, in Virginia Tax Review, Vol. 25 (2005) No. 2, p. 328; Lokken, L. *Whatever Happened to Subpart F ? U.S. CFC Legislation After the Check –the-Box Regulations*, in Florida Tax Review, Vol. 7 (2005 – 2006), No. 3, p. 189.

*provision that was intended to override (or that may arguably have the effect of overriding) tax treaties.*<sup>38 39</sup>

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- <sup>38</sup> Infanti, A. C., *United States*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 366
- <sup>39</sup> It is interesting to report the list of treaty overrides realized in those years as described by Sachs. This makes clearer how the attitude of the U.S. legislator in favour of treaty override was gradually developed up until to the amendment of the Internal Revenue Code which reverted the relationship between national law and previously concluded tax treaties. See Sachs, D., *Is the 19<sup>th</sup> Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, in *Tax Lawyer*, Volume 47 (1993- 1994), No. 4, pp. 871 – 873:
- ‘B. *Foreign Investors Tax Act 1966*  
The 1966 Act reverted to the practice of respecting treaties. Section 110 of the 1966 Act provided that “[n]o amendments made by this title shall apply in any case where its application would be contrary to any treaty obligation of the United States.” Further, it added Code section 894(b) to assure that treaty exemptions for dividends and interests, not effectively connected with a United States business, would be available to foreign persons having a permanent establishment in the United States.
  - C. *Tax reduction Act of 1975*  
Section 601 of the 1975 Act added Code sections 901(f) and 907, governing foreign tax credits with respect to income from oil and gas . No statement was made in the Act or congressional committee reports regarding the effect of these enactments on treaties. However, on the basis of inferences drawn from statements in the committee reports on the Tax Reform Act of 1976, the Service ruled that these sections did override any inconsistent treaty provision.
  - D. *Tax Reform Act of 1976*  
Section 1031 of the 1976 Act amended Code section 904 to repeal the per-country limitation for foreign tax credit purposes. The Act did not state whether the repeal was intended to supersede inconsistent treaty provisions, but the committee reports did state such an intention. On this basis, the Service ruled that the amendment to Code section 904 superseded contrary treaty provisions.
  - E. *Foreign Investment in Real Property Tax Act of 1980*  
The 1980 Act added Code Section 897, imposing tax on gains of foreign persons who disposed of direct and indirect interests in the United States real property. Section 1125(c) of the Act expressly provided for treaty override, though it mitigated the effect of the override by allowing a deferred effective date (1985) for the override and even further deferral of up to two years if an inconsistent treaty was renegotiated and signed before January 1, 1985. Also, section 897(i) permitted foreign corporations to elect to be treated as domestic corporations in order to avoid discriminatory treatment. The 1980 Act was the first tax statute after the 1962 Act to include statutory treaty-override language.
  - F. *Tax Reform Act of 1984*  
Section 121(a) of the 1984 Act added Code section 904(g) recharacterizing the source of certain income from United States-owned foreign corporations. Senate committee reports on treaty ratifications indicated that the treaties were not intended to override section 904(g). Subsequently, the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) retroactively amended section 904(g) to govern its co-ordination with treaties.
  - G. *Tax Reform Act of 1986*



With the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) the Internal Revenue Code was modified<sup>40</sup>. The possibility of treaty override was clearly codified in general terms.

The previous text of art. 894 (a) of the Internal Revenue Code was replaced with the following:

(a) *Treaty Provisions*

- (1) *In General - The provisions of this title shall be applied to any taxpayer with due regard to any treaty obligation of the United States which applies to such taxpayer.*
- (2) *Cross Reference – For relationship between treaties and this title, see section 7852(d).*

The full extent of this change is completely understandable only with reference to section 7852(d) which was also amended as follows:

(d) *Treaty Obligations*

- (1) *In General- For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law*
- (2) *Savings Clause for 1954 Treaties – No provision of this title (as in effect without regard to any amendment thereto enacted after August 16, 1954) shall apply in any case where its application would be contrary to any treaty obligation of the United States in effect on August 16, 1954.*

In 1988 there was a legislative affirmation of the ‘later in time’ rule which – in fact – has definitively and generally legitimized treaty override in the U.S.

The Senate Report that accompanied the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) was an ‘extended defence of the U.S. position on treaty overrides’<sup>41</sup>. As a part of the legislative history of the TAMRA, the Senate Report explained the U.S. treaty override doctrine according to what has been reported in this paragraph.

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The 1986 Act made a number of changes in the tax law that were inconsistent with, or might be viewed as inconsistent, with treaties. The Act and the committee reports, however, included only a few express treaty-override provisions. However, TAMRA, made significant changes in treaty obligations, which were stated to be retroactively applicable to the 1986 Act.’

<sup>40</sup> Infanti, A. C., *United States*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 369; Sachs, D., *Is the 19<sup>th</sup> Century Doctrine of Treaty Override Good Law for Modern Day Tax Treaties?*, in Tax Lawyer, Volume 47 (1993 – 1994), No. 4, p. 873.

<sup>41</sup> Avi-Yonah, R. S., *Tax Treaty Overrides: A qualified Defence of U.S. Practice*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 68.



There is a remaining aspect that needs to be considered, i.e. the role of the legislator's will in order to override a tax treaty.

Under the Supreme Court case law there is a 'presumption of harmony' according to which the legislator had no intention to override a previous international treaty. Consequently, an interpretation which gives effect to both domestic law and international treaty should prevail when possible.<sup>42</sup>

The Senate Report explicitly mentions the 'presumption of harmony' as elaborated by the Supreme Court and quotes the relevant case law<sup>43</sup>: *'The cardinal rule is that repeals by implication are not favored. Where there are two acts upon the same subject, effect should be given to both if possible ... [T]he intention of the legislature to repeal must be clear and manifest.'*<sup>44</sup> *'When the two [a treaty and a later statute] relate to the same subject, the courts will always endeavor to construe them so as to give effect to both, if that can be done without violating the language of either.'*<sup>45</sup> *'A treaty will not be deemed to have been abrogated or modified by a later statute unless such purpose on the part of Congress has been clearly expressed'*<sup>46</sup>

Nevertheless, the Senate Report concludes on the point by emphasizing that when an actual conflict exists and an interpretation that harmonizes domestic law and international treaty is not possible, the later conflicting domestic law prevails.<sup>47</sup> According to the Senate Report, therefore, an explicit will to override a previous treaty is not indispensable when an actual conflict exists and it cannot be solved through interpretation.<sup>48</sup>

## 2.2. The new developing Italian system refusing treaty override

Article 10(1) of the Italian Constitution has a quite peculiar and innovative formulation, notwithstanding it was introduced already in 1948. It does not simply state that customary law applies automatically within the Italian legal system.

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<sup>42</sup> Infanti, A. C., *United States*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 370.

<sup>43</sup> Excerpts from Senate Finance Committee Report No. 100 – 445, 100<sup>th</sup> Cong., 2d Sess. (August 3, 1988) to accompany S. 2238 (Technical Corrections Act of 1988), "II, XII; H. Miscellaneous Foreign Provisions, 1. Relationship with Treaties" (sec. 112(aa) of the bill, Title VII and Title XII of the Reform Act, and sec. 7852 of the Code), in *Tax Notes International*, Vol. 1 (1989), No. 6, p. 603.

<sup>44</sup> *Posadas v. National City Bank*, 296 U.S. 497, 503 (1936).

<sup>45</sup> *Whitney v. Robertson*, 124 U.S. 190, 194 (1888).

<sup>46</sup> *Cook v. United States*, 288 U.S. 102, 129 (1933).

<sup>47</sup> Excerpts from Senate Finance Committee Report No. 100 – 445, 100<sup>th</sup> Cong., 2d Sess. (August 3, 1988) to accompany S. 2238 (Technical Corrections Act of 1988), "II, XII; H. Miscellaneous Foreign Provisions, 1. Relationship with Treaties" (sec. 112(aa) of the bill, Title VII and Title XII of the Reform Act, and sec. 7852 of the Code), in *Tax Notes International*, Vol. 1 (1989), No. 6, p. 603.

<sup>48</sup> See also Avi-Yonah, R. S., *Tax Treaty Overrides: A qualified Defence of U.S. Practice*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 70.

Art. 10(1) states that the ‘*Italian legal system conforms to generally recognized norms of international law*.’<sup>49</sup> This means that the Italian legal order must automatically adapt itself to the rules of international customary law.

As a consequence, the Italian Constitutional Court ruled that international customary law has constitutional rank within the Italian hierarchy of law<sup>50</sup>.

The Italian Constitutional Court has never accepted the (though minority) view of some Italian scholars<sup>51</sup> according to which art. 10(1) of the Constitution would guarantee automatic validity and direct applicability to treaty provisions<sup>52</sup>. Consequently, before the important constitutional reform implemented in 2001, a treaty transformed into national law could be amended by a subsequent law of equal rank within the national hierarchy. Indeed, treaty override was possible. However, it needs to be emphasized that according to the Italian case law violation of international treaties was avoided to the extent that the *lex specialis* rule could apply<sup>53</sup>.

According to Gaja, the special character of international treaties would derive from their ‘more limited subject-matter.’<sup>54</sup>

In 2001, part of the Italian Constitution (‘titolo V’) has been significantly amended and now art. 117(1) expressly states that the legislative power (either central and regional) is limited by international treaty obligations.

This provision has significantly changed the Italian system and determined an extremely important openness toward international law by the Italian Constitutional Court starting with the two judgments No. 348/2007 and No. 349/2007.

<sup>49</sup> This is the English translation used in Gaja, G., *Italy*, (chapter 5), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, p. 88.

<sup>50</sup> Cannizzaro, E. and Caligiuri, A., Art. 10, in Bifulco, R., Celotto, A. and Olivetti, M. (editors), *Commentario alla Costituzione*, Volume primo, Artt. 1-54, UTET GIURDICA, p. 248.

<sup>51</sup> See especially Quadri, R., *Diritto internazionale pubblico*, 5th edition, Liguori, 1968, p. 63 *et seq.*

<sup>52</sup> See Cassese, A., *Lo Stato e la comunità internazionale (Gli ideali internazionalistici del Costituente)*, in Branca, G. (editor), *Commentario della Costituzione, Principi fondamentali, Artt. 1-12*, Nicola Zanichelli Editore Bologna, Soc. ed. del Foro italiano – Roma, 1975, p. 506; Gaja, G., *Italy*, (chapter 5), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, pp. 88 – 89; *Ex plurimis*, Constitutional Court, judgments (sentenze) No. 153/1987, No. 168/1994, No. 288/1997, No. 32/1999.

<sup>53</sup> Gaja, G., *Italy*, (chapter 5), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, p. 99.

<sup>54</sup> Gaja, G., *Italy*, (chapter 5), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, p. 99.

Although they specifically concerned the compliance of a domestic provision with the European Convention on Human Rights, general principles regarding the relationship between international and national law have also been expressed<sup>55</sup>. The Court explicitly pointed out that art. 117(1) has determined the passage to a system that does not allow any longer to override a domestic law incorporating an international treaty through a subsequent conflicting law having the same rank within the national hierarchy of law (*lex posterior abrogat priori*).

Specifically, the Constitutional Court stated its exclusive competence to repeal a domestic law in conflict with an international obligation. This means, indeed, that constitutional judicial proceedings are necessary to declare a national provision illegitimate because it is in contrast with international treaty obligations.

The position of the lower courts is still not completely clear. Certainly, they cannot autonomously set aside a law which is considered in conflict with an international obligation. However, while in the judgment No. 348/2007 the Constitutional Court seems to exclude any competence of the lower courts, i.e. in any case of possible conflict they have to submit the question to the Constitutional Court, in the judgment No. 349/2007 the possibility is recognized that a lower judge applies domestic law when it can be interpreted so that any conflict with international treaty provisions is avoided.

Regardless of the uncertainties that still exist, what is important to emphasize is that only a judgment of the Constitutional Court can eventually establish whether domestic law is in conflict with international treaty obligations. The principle *lex posterior abrogat priori* no longer applies. In case the Constitutional Court judges domestic law in conflict with international treaty obligations the first is considered illegitimate and repealed from the Italian legal system.

This is an extremely important aspect of the reform. In case of treaty override a taxpayer can question the legitimacy of domestic law directly under art. 117(1) of the Constitution by adducing the violation of an international obligation. This is because the Italian Constitution now protects a general principle according to which international obligations must be respected. This general principle guarantees protection to citizens every time an international obligation is breached. In the past the Constitutional Court could declare illegitimate a domestic law that breached an international treaty obligation only indirectly, when there was a conflict between domestic law and a specific constitutional provision.

Contrary to international customary law, treaty obligations have no constitutional rank in the national hierarchy of law. They are considered immediately lower to the Constitution.

Finally, there are two specific tax provisions that need to be mentioned. On the one hand, article 75 of the Presidential Decree No. 600/1973 expressly states the

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<sup>55</sup> Cannizzaro, E., *Sentenze della Corte europea dei diritti dell'uomo e ordinamento italiano in due recenti decisioni della Corte Costituzionale*, in *Rivista di diritto internazionale*, 2008, No. 1, p. 138.

prevalence of tax treaty provisions on domestic law. On the other hand, art. 169 of the Italian Income Tax Act (Presidential Decree No 917/1986 – Testo Unico delle imposte sui redditi) establishes an exception to this rule: domestic law prevails over tax treaty provisions when the first is more favourable to taxpayers. This provision is still considered applicable even after the 2001 constitutional reform<sup>56</sup>.

### 2.3. Germany: a new position of the Federal Tax Court seems to undermine the long tradition in favour of treaty override

In Germany the Federal legislature is competent in the field of international tax treaties. According to art. 59(2)(1) of the German Federal Constitution (*Grundgesetz* – GG): “*Treaties that regulate the political relations of the Federation or relate to subjects of federal legislation shall require the consent or participation, in the form of a federal law, of the bodies responsible in such a case for the enactment of federal law*”<sup>57</sup>. An international treaty, either self executing or non self executing, needs the consent of the Bundestag to be ratified by the President.

The German legislature has, therefore, the function to check the compliance of international treaties with domestic law<sup>58</sup>.

The Bundestag has only a formal role in the treaty making process. Specifically, in case of a conflict with domestic law it can only deny its consent<sup>59</sup>. However, according to art. 59(2)(1) GG, a federal law is necessary to incorporate an international treaty and to make it applicable within the German legal system<sup>60</sup>

<sup>61</sup> (‘Transformationsakt’).

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<sup>56</sup> Bracco, P., *Italy*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 261 – 264.

<sup>57</sup> Vogel, K., *New Europe Bids Farewell to Treaty Override*, in Bulletin for International Fiscal Documentation, (2004) Vol. 58, No. 1, p. 8. Vogel specifies in footnote n. 25 that the ‘[t]ranslation [is] by Prof. Dr. Christian Tomuschat, Berlin and Prof. David P. Curry, Chicago. Published by the Press and Information Office of the Federal Government.’

<sup>58</sup> Steiger, S., *The Relationship of German National Law with Public International Law and the European Community Law*, in Vandamme, T.A.J.A. and Reestman, J. (editors), *Ambiguity in the Rule of Law. The Interface between National and International Legal Systems*, Europa Law Publishing 2001, p. 70.

<sup>59</sup> Steiger, S., *The Relationship of German National Law with Public International Law and the European Community Law*, in Vandamme, T.A.J.A. and Reestman, J. (editors), *Ambiguity in the Rule of Law. The Interface between National and International Legal Systems*, Europa Law Publishing 2001, p. 70.

<sup>60</sup> Eilers, S., *Override of Tax Treaties Under the Domestic Legislation of the U.S. and Germany*, in Tax Management International Journal, (1990) Vol. 49, No. 7, p. 296; Frowein, J. A., *Federal Republic of Germany* (chapter 4), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law* – United Kingdom National Committee of Comparative Law, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxwell, 1987, p. 66.

<sup>61</sup> Indeed, in case of a non self executing treaty the Bundestag will modify national law ‘directly by statute or by referring to later legislative acts’. See Steiger, S., *The Relationship*

As a consequence, an international treaty acquires the same rank that federal legislation has within the national hierarchy of law<sup>62</sup> and a federal law incorporating a tax treaty can be overridden by a subsequent federal law<sup>63</sup>. This is the position that the German Federal Tax Court (Bundesfinanzhof) has taken<sup>64</sup> (at least until very recently, as it will be explained below). In particular, the German Federal Tax Court has adhered to Triepel's theory according to which a Federal statute incorporating an international treaty is the 'mirror image of the international treaty'<sup>65</sup>. It is not the international treaty to be applied within the domestic system but the national federal statute<sup>66</sup>.

On the other hand, section 2 of the German Tax Code (Abgabenordnung) establishes that tax treaties prevail over federal legislation: "*Treaties with foreign states concluded under Art. 59 para 2 of the Constitution concerning tax matters take precedence over tax legislation where they have become immediately applicable internal law*"<sup>67</sup>. As a rule, tax treaty provisions should be applied even in case of posterior conflicting domestic federal laws.

This principle was applied in German case law even before the adoption of section 2 of the Tax Code<sup>68</sup>. The provision at issue has, however, been object

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of German National Law with Public International Law and the European Community Law, in Vandamme, T.A. J.A. and Reestman, J. (editors), *Ambiguity in the Rule of Law. The Interface between National and International Legal Systems*, Europa Law Publishing 2001, p. 68.

<sup>62</sup> Eilers, S., *Override of Tax Treaties Under the Domestic Legislation of the U.S. and Germany*, in Tax Management International Journal, (1990) Vol. 49, No. 7, p. 296; Frowein, J. A., *Federal Republic of Germany* (chapter 4), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, p. 67.

<sup>63</sup> Frowein, J. A., *Federal Republic of Germany* (chapter 4), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, p. 67.

<sup>64</sup> Rust quotes as 'leading' case law: 'BFH BStBl. II 1995, p. 129 et seq.; BStBl. II 1998, p. 113 et seq.' See Rust, A., Germany, in Maisto, G., (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 237, footnote No. 17.

<sup>65</sup> Vogel, K., *New Europe Bids Farewell to Treaty Override*, in Bulletin for International Fiscal Documentation, (2004) Vol. 58, No. 1, p. 8.

<sup>66</sup> Vogel, K., *New Europe Bids Farewell to Treaty Override*, in Bulletin for International Fiscal Documentation, (2004) Vol. 58, No. 1, p. 8.

<sup>67</sup> Frowein, J. A., *Federal Republic of Germany* (chapter 4), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, p. 67.

<sup>68</sup> See Eilers, S., *Override of Tax Treaties Under the Domestic Legislation of the U.S. and Germany*, in Tax Management International Journal, (1990) Vol. 49, No. 7, p. 296.

of extensive debate among German scholars.<sup>69</sup> Some of them have maintained the prevalence of tax treaty *tout court* under section 2 of the Tax Code. Others have affirmed the nature of *leges speciales* of tax treaties and consequently their prevalence over domestic law.

However, the position presently prevailing is that the German Tax Code is federal legislation itself and consequently it cannot limit the scope of an equal source intended to override a previous international treaty<sup>70</sup>.

German courts tend to avoid the violation of international treaty obligations through the application of the *lex specialis* principle, i.e. a tax treaty is considered *lex specialis* thus prevailing over more general federal legislation. However, treaty override in practice occurs when the legislature clearly expresses its intention to amend a previous treaty<sup>71</sup>.

According to the position prevailing both in literature and case law, treaty override is lawful within the national system, although it realizes a breach of international law<sup>72</sup>.

There is however a minority<sup>73</sup> of scholars who deny the legitimacy of treaty override in Germany. The most authoritative is Klaus Vogel. He contests the prevailing stance according to which articles 59(2)(1) and 25 of the German Federal Constitution allow treaty override.

Article 25 of the Federal Constitution states that ‘*The general rules of international law shall be an integral part of federal law. They shall take precedence over the laws and directly create rights and duties for the inhabitants of the federal territory.*’

Vogel is of the opinion that nothing within art. 25 of the German Constitution excludes international treaty obligations from its scope. The fact that some special rules are clearly excluded (i.e. administrative treaties concluded by the executive under art. 59(2)(2) of the Constitution) does not necessarily imply that all special rules are<sup>74</sup>.

With regard to art. 59(2)(1) of the Federal Constitution, Vogel contests the position according to which it is the federal statute incorporating the international treaty that applies within the national system and not the international treaty itself. From Vogel’s point of view this cannot be inferred from art. 59(2)(1) which

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<sup>69</sup> Eilers, S., *Override of Tax Treaties Under the Domestic Legislation of the U.S. and Germany*, in *Tax Management International Journal*, (1990) Vol. 49, No. 7, pp. 296 – 297.

<sup>70</sup> See Rust, A., Germany, in Maisto, G., (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 237-238.

<sup>71</sup> See Rust, A., Germany, in Maisto, G., (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 238.

<sup>72</sup> See Rust, A., Germany, in Maisto, G., (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, 237.

<sup>73</sup> See Rust, A., Germany, in Maisto, G., (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 238.

<sup>74</sup> Vogel, K., *New Europe Bids Farewell to Treaty Override*, in *Bulletin for International Fiscal Documentation*, (2004) Vol. 58, No. 1, p. 8.

‘requires only the *form* of a federal statute’<sup>75</sup>. Vogel emphasizes that, contrary to the UK system, a German federal statute has only the function to approve an international treaty before its conclusion and not to implement it <sup>76</sup>.

In conclusion, according to Vogel neither art. 25 nor art. 59(2)(1) of the German Constitution offer a clear solution about the relationship between federal statutes and international tax treaties. This allows an interpretation based on the constitutional principle of ‘Rechtsstaat’, i.e. an interpretation which fills a lack of the law referring to ‘the general sense of justice, of right and wrong’<sup>77</sup>

In this case, according to Vogel, reference is necessary to the actual status of international law as implemented by states through their constitutional provisions. Vogel emphasizes a general constitutional trend toward the recognition of international law as prevailing over national law<sup>78</sup>.

*‘For these reasons, I pronounce myself firmly in favour of giving precedence to international treaties under German constitutional law. At present, I am still a minority of one. But other experts have expressed their support, though not yet in writing, and I have no doubt that, in the end, this conviction will become generally accepted. I hope, of course, that the same will happen in other countries ... In contrast, it would not be realistic to expect the same from countries which follow the United Kingdom’s system or from the United States. But at least these states might become more reluctant to override treaties if they realize to what extent this is disapproved by constitutional law in other parts of the worlds’.*<sup>79</sup>

The trend that Vogel predicted is maybe now developing in Germany since the Federal Tax Court has requested the Federal Constitutional Court to decide about a case of tax treaty override<sup>80</sup>.

The case specifically concerns an individual resident in Germany who was employed in Turkey. According to the applicable tax treaty, which was concluded in 1985 and now replaced, the relevant income is exempt in Germany.

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<sup>75</sup> Vogel, K., *New Europe Bids Farewell to Treaty Override*, in Bulletin for International Fiscal Documentation, (2004) Vol. 58, No. 1, p. 8.

<sup>76</sup> Vogel, K., *New Europe Bids Farewell to Treaty Override*, in Bulletin for International Fiscal Documentation, (2004) Vol. 58, No. 1, p. 8.

<sup>77</sup> Vogel, K., *New Europe Bids Farewell to Treaty Override*, in Bulletin for International Fiscal Documentation, (2004) Vol. 58, No. 1, p. 8.

<sup>78</sup> Vogel, K., *New Europe Bids Farewell to Treaty Override*, in Bulletin for International Fiscal Documentation, (2004) Vol. 58, No. 1, pp. 6,8. See also Vereshchetin, H. E. V. S., *Some Reflections on the Relationship Between International Law and National Law in the light of New Constitutions*, in *Constitutional Reform and International Law in Central and Eastern Europe*, edited by Müllerson, R., Fitzmaurice, M. and Andrenas, M., Kluwer Law International, 1998, pp. 11 – 13.

<sup>79</sup> Vogel, K., *New Europe Bids Farewell to Treaty Override*, in Bulletin for International Fiscal Documentation, (2004) Vol. 58, No. 1, p. 8.

<sup>80</sup> Bundesfinanzhof, 10.01.2012, IR 66/09. The proceedings are currently suspended while the decision of the Constitutional Court is pending.



The applicable treaty expressly states that an exemption should be granted even in case the taxpayer, actually subjected to tax in Turkey, did not exactly carry out the required procedure there<sup>81</sup>.

In fact, the taxpayer was not able to prove in Germany that the relevant income had actually been taxed in Turkey.

According to section 50d(8) of the German Income Tax Act, when a taxpayer is not able to prove the actual taxation in the other contracting state, Germany has the right to tax, regardless of any tax treaty provisions.

In fact, section 50d(8) of the German Income Tax Act allows a treaty override by substituting the credit method for the exemption method (so-called switch-over clause) which is usually introduced in the double tax conventions concluded by Germany.

With this referral to the Constitutional Court the Federal Tax Court supersedes its previous position about treaty override and considers a breach of an international treaty unconstitutional.

As mentioned above, in the past the Federal Tax Court held the national legitimacy of treaty override on the basis of article 59(2)(1) of the German Constitution. The federal law incorporating an international treaty could be overridden by a subsequent federal law.

In the case at issue the Federal Tax Court recalls some judgments of the German Constitutional Court concerning the European Convention on Human Rights<sup>82</sup>. In those judgments, supporting a new interpretative position, the German Constitutional Court stated that art. 59(2)(1) of the Constitution does not release Germany from respecting the undertaken international obligations. Regardless of the formal transformation concerned with the treaty making process in Germany, an objective international obligation continues to exist and Germany (i.e. all its organs) is not allowed to breach it. According to the Constitutional Court, this limit stems from article 20(3) of the German Constitution which establishes the German rule of law: *'The legislature shall be bound by the constitutional order, the executive and the judiciary by law and justice'*. Only the Constitutional Court can individuate well-founded (exceptional) reasons to allow a breach of an international obligation.

The Federal Tax Court, in the case at issue, develops a partially different reasoning. Section 50d(8) of the German Income Tax Act is considered to have realized a case of tax treaty override under art. 25 of the Constitution. This article, as mentioned above, establishes the prevalence of the general rules of international law over federal law.

The Federal Tax Court considers the rule *pacta sunt servanda* included among the general rules of international law. As a consequence, also treaty provisions can be considered prevailing over federal law under the German Constitution. The

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<sup>81</sup> A new Double Tax Convention between Germany and Turkey has been concluded with effect as from the 1<sup>st</sup> of January 2011. This provision has now been repealed.

<sup>82</sup> BVerfGE 111, 307; BVerfGE 112, 1; BVerfGE 128, 326.



Federal Tax Court adds that there are no plausible reasons that could found an exception to the breach of the international agreement between Germany and Turkey. In particular, it has not been proved that a case of double non-taxation has occurred.

The position stating the occurrence of a tax treaty override is furthermore argued on the basis of art. 20(3) of the German Constitution that binds the national legislature upon the limits established by law. This argument is supported in combination with article 2(1) of the German Constitution, according to which *‘[e]very person shall have the right to free development of his personality insofar as he does not violate the rights of others or offend against the constitutional order or the moral law’*. The violation of this constitutional provision realizes a breach of fundamental rights (the so-called *Gesetzesvorbehalt*).

In addition, the Federal Tax Court states that section 50d(8) of the German Income Tax Act breaches the principle of equality under art. 3 of the Constitution because it is applicable only to income derived by employees.

Notably, the Federal Tax Court excludes that section 50d(8) of the German Income Tax Act could be interpreted so that a tax treaty override could be avoided.

If the German Constitutional Court confirms its previous decision the impact on the German system would be considerable. The future admissibility of tax treaty override should, indeed, be completely reconsidered.

#### 2.4. *The Netherlands and its position against treaty override*

Historically, as a trade country, the Netherlands has always had an extremely open attitude toward international law. Customarily<sup>83</sup>, sources of international law are automatically valid within the Dutch national system. This means that international law does not need to be transformed into national law, unless the relevant treaty expressly requires transformation<sup>84</sup>. Tax treaties are usually automatically valid within the national Dutch system<sup>85</sup>.

*‘International law thus has validity by virtue of its international quality. It does not have to be transformed, nor does it work in the domestic legal order by virtue of an “implicit” transformation act into the “law of the land”’*.<sup>86</sup>

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<sup>83</sup> Schermers, H.G., *Netherlands* (chapter 6), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxwell, 1987, p. 109.

<sup>84</sup> For example, private international law treaties are usually transformed into national law. See, Pijl, H., *Netherlands*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 283.

<sup>85</sup> Pijl, H., *Netherlands*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 283.

<sup>86</sup> Pijl, H., *Netherlands*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 283.

Nevertheless, the automatic validity of international law does not necessarily imply the direct applicability, i.e. the self executive nature<sup>87</sup>, of the sources of international law. According to article 93 of the Dutch Constitution, ‘[p]rovisions of treaties and of resolutions by international institutions, which may be binding on all persons by virtue of their contents shall become binding after they have been published.’<sup>88</sup> There are, therefore, two requisites that guarantee the direct applicability of treaty provisions within the Dutch national system. They (1) need to be published and, at the same time, they (2) need to be ‘binding on everyone’<sup>89</sup>. In turn, treaty provisions can be considered ‘binding on everyone’ when they are objectively complete, i.e. their content does not need to be integrated by national law and, from a subjective point of view they are addressed to private parties and not to the state.

The existence of the two requisites is a matter of interpretation. Courts decide case by case when they are met<sup>90</sup>.

According to article 94 of the Dutch Constitution, ‘Statutory regulations in force within the Kingdom shall not be applicable if such application is in conflict with provisions of treaties that are binding on all persons or resolutions by international institutions.’<sup>91</sup>

Art. 94 of the Dutch Constitution, therefore, guarantees priority of treaty provisions over domestic law only to the extent that they have direct effect according to art. 93 of the Constitution.

It is important to point out that treaty provisions prevail even on the Dutch Constitution when they have direct effect.

‘Dutch courts are not entitled to question the validity of treaties. In that respect treaties are equal to statutes. According to the old theory of the separation of powers, it is for parliament to decide whether a law (or a treaty) is in conformity with the Dutch Constitution. Courts are not entitled to question the legality of Acts of Parliament.’<sup>92</sup>

<sup>87</sup> Schermers, H. G., *Netherlands* (chapter 6), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law* – United Kingdom National Committee of Comparative Law, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, p. 114.

<sup>88</sup> Schermers, H. G., *Netherlands* (chapter 6), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law* – United Kingdom National Committee of Comparative Law, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, p. 112.

<sup>89</sup> Pijl, H., *Netherlands*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 285.

<sup>90</sup> Schermers, H. G., *Netherlands* (chapter 6), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law* – United Kingdom National Committee of Comparative Law, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, pp. 114 – 116.

<sup>91</sup> Schermers, H. G., *Netherlands* (chapter 6), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law* – United Kingdom National Committee of Comparative Law, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, pp. 112 – 113.

<sup>92</sup> Schermers, H. G., *Netherlands* (chapter 6), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law* – United Kingdom National Committee of Comparative

Article 120 of the Dutch Constitution expressly excludes the competence of courts to judge the constitutionality of statutes or treaties.

It is consequently only within the power of the Dutch parliament to establish whether a treaty is in conflict with the Constitution and whether, regardless of the conflict, the treaty is to be approved.

Indeed, when such a conflict exists the explicit<sup>93</sup> procedure of treaty parliamentary approval is required and the treaty needs to receive a two-thirds majority<sup>94</sup> of votes (art. 6 of the Realm Act Approval and Publications of Treaties).

The Dutch system is clearly against any form of treaty override. This has extremely important consequences first of all with regard to taxpayers' protection. Dutch courts can set aside domestic legislation (but not declare their invalidity, as explained above) when a case of treaty override has occurred. Taxpayers, therefore, can invoke directly the violation of treaty provisions under articles 93 and 94 of the Dutch Constitution.

This strong Dutch position against treaty override has entirely permeated the Dutch courts attitude toward international law. The most important consequence is, indeed, the position of the Dutch Supreme Court ('Hoge Raad der Nederlanden') according to which the national *fraus legis* doctrine is applicable for treaty purposes only to the extent that the recharacterization of facts as conducted by the tax administration is compliant with the relevant tax treaty<sup>95</sup>. This reflects the general interpretative attitude of the Dutch Supreme Court. Interpretation of treaty provisions is always the starting point when a possible case of treaty override needs to be analyzed. Any evaluation is conducted on the basis of the compliance of domestic law with treaty provisions<sup>96</sup>.

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Law, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxwell, 1987, p. 113.

<sup>93</sup> Art. 91(2) of the Dutch Constitution establishes the possibility that an international treaty is approved by the parliament following a tacit procedure. It states literally: 'The law shall regulate how the approval is granted and can provide for tacit consent'. Art. 3 of the Realm Act Approval and Publications of Treaties establishes that an international treaty can be approved by the Dutch parliament explicitly or tacitly. Art. 5 of the Realm Act Approval and Publications of Treaties establishes that an international treaty is intended tacitly approved by the parliament when the treaty has been presented by the government for tacit approval and the parliament has not expressed its will for an explicit approval procedure (approval by law) within thirty days. See Pijl, H., *Netherlands*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax law Series, Vol. 2, IBFD Publications BV, 2006, pp. 289 – 290.

<sup>94</sup> The two-thirds majority is required for constitutional amendments.

<sup>95</sup> See *infra* chapter V.

<sup>96</sup> This position of the Dutch Supreme Court will be extensively clarified in the course of this study.

### 3. National implementation of international law and the will of states

The country analysis conducted above has taken into consideration four national systems that show, with respect to the application of international treaties – and in general of international law – that domestic regimes are extremely varied<sup>97</sup>. It has often been highlighted – mostly in connection with a dualist approach<sup>98</sup> – that an exact understanding of the relationship between international and national law requires to emphasize that the application of international law within the national system is in fact based on the individual will of states<sup>99</sup>.

Jacobs observed that, ‘... the effect of international law generally, and of treaties in particular, within the legal order of a State will always depend on a rule of domestic law. The fundamental principle is that the application of treaties is governed by domestic constitutional law. It is true that domestic law may, under certain conditions, require or permit the application of treaties which are binding on the State, even if they have not been specifically incorporated into domestic law. But this application of treaties “as such” is prescribed by a rule of domestic constitutional law. It is not a situation reached by the application of a rule of international law, since such a rule, to have effect, itself depends upon recognition by domestic law. Indeed international law is generally uninformative in this area since it simply requires the application of treaties in all circumstances. It does not modify the fundamental principle that the application of treaties by domestic courts is governed by domestic law.’<sup>100 101</sup>

<sup>97</sup> See also Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006; Cassese, A., *International Law*, Oxford University Press, second edition, 2005, p. 220: ‘A survey of national systems shows a conspicuous lack of uniformity.’; Hollis, D. B., Blakeslee, M. R. and Ederington, L. B. (editors), *National Treaty Law and Practice*, The American Society of International Law, 2005; M. Lang (editor), *Tax Treaty Interpretation*, EUCOTAX Series on European Taxation, Volume 3, Kluwer Law International, 2001; Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxwell, 1987.

<sup>98</sup> Gaja, G., *Dualism – A Review*, in Nijman, J. and Nollkaemper, A. (editors), *New Perspectives on the Divide Between National & International Law*, cit., p. 58 : ‘The implication of the self-contained character that dualists attribute to the international and municipal legal systems is that, within each system, rules pertaining to a different system are not per se relevant. They only become so if a rule that belongs to the system incorporates a foreign rule or gives the foreign rule some other legal effect.’

<sup>99</sup> See Vereshchetin, H. E. V. S., *Some Reflections on the Relationship Between International Law and National Law in the light of New Constitutions*, in *Constitutional Reform and International Law in Central and Eastern Europe*, edited by Müllerson, R., Fitzmaurice, M. and Andrenas, M., Kluwer Law International, 1998, p. 7.

<sup>100</sup> Jacobs, F. G., Introduction, in Jacobs, F. G. and Roberts, S., *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxwell, 1987, p. XXIV.

<sup>101</sup> See also Steiger, H., *The Relationship of German National Law with Public International Law and the European Community Law* (chapter VI), in Vandamme, T. A. J. A. and Reestman, J. (editors), *Ambiguity in the Rule of Law. The Interface between National and International Legal*

Cassese pointed out that the variety of national systems governing the implementation of international law reveals the conviction of states that “*the translation of international commands into domestic legal standards is part and parcel of their sovereignty*”<sup>102</sup>.

This is exactly the core of our problem, as already emphasized above in this chapter. This states’ conviction explains the subjective regulation of the relationship between national and international law that the above country analysis has showed.

In fact, one point is clear: when international law is considered automatically valid within the national legal order, treaty override is not permitted since international law is considered prevailing over national law<sup>103</sup>. On the contrary, when domestic legislation requires ‘transformation’ of international law into domestic law the principle of interpretation *lex posterior abrogat priori* applies<sup>104</sup>. In this case a newly introduced national law can override a previous international treaty<sup>105</sup>.

This general principle is not contradicted in the United States where transformation is not required only because international law is directly equated to national legislation by virtue of a constitutional provision, i.e. the Supremacy Clause. According to the Supremacy Clause both international treaties and domestic laws are Supreme Law of the Land. Since the two sources of law have the same rank within the national hierarchy, the ‘later in time’ rule applies. A newly adopted federal law can override a previous treaty.

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*Systems*, Europa Law Publishing, 2001, p. 67: ‘Even if one follows the monistic conception, which is in my opinion more adequate to construct the relationship between public international law and national law, we have to acknowledge that sovereignty guards the internal order against any international law entering without specific permission. Therefore, international legal norms which are self-executing need an act of recognition in order to form part of the national legal order. The norms remain international legal norms, but they become part of the legal order of the state, creating rights and duties for the legal subjects concerned, and are binding upon the courts, administrative agencies and so on.’

<sup>102</sup> Cassese, A., *International Law*, Oxford University Press, second edition, 2005, p. 220.

<sup>103</sup> The scope of this rule may be limited only by national constitutions. In most states, even when international law is considered automatically valid, it has the same rank as constitutional provisions. Consequently, international law can be overridden through constitutional legislation.

<sup>104</sup> In some states treaties are considered *lex specialis* prevailing over *lex generalis*. Nevertheless, in most of the states where this rule applies, a treaty override is admitted when a general law includes the will of the national legislator to override a previous treaty. See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 71.

<sup>105</sup> The only exception is represented by the Italian system after the 2001 constitutional reform. International law keeps to be incorporated into national law. However, treaties can no longer be overridden through the application of the rule *lex posterior abrogat priori*.

This constitutional system has technically founded the U.S. doctrine in favour of treaty override.

It is worth noting that the Supreme Court has – as a premise to his doctrine – explained why an international agreement can be equated to a unilateral domestic act.

Also in this case the Supremacy Clause has had a central role. In the U.S. system, exactly by virtue of the Supremacy Clause, international agreements are assumed to have unilateral character. Emblematic the *Foster v. Neilson* case: ‘*A treaty is in its nature a contract between two nations, not a legislative act.*

... *In the United States a different principle is established. Our Constitution declares a treaty to be the law of the land. It is, consequently, to be regarded in courts of justice as equivalent to an act of the legislature, whenever it operates of itself without the aid of any legislative provision.*<sup>106</sup>

The German system envisages a process of transformation. International law cannot be directly applied within the national legal system and, therefore, it is incorporated within a federal statute. According to the position that the Federal Tax Court has maintained until recently, a federal statute ‘mirrors’ the incorporated treaty and it is directly applied instead of the international agreement. As a consequence, a federal law incorporating an international treaty can be amended through a subsequent federal law (precisely because they have the same rank within the national hierarchy).

Exactly the same system was applied in Italy until the 2001 constitutional reform. Before 2001 a national law incorporating an international treaty could be amended by a subsequent national law having the same rank within the national hierarchy (through the application of the rule *lex posterior abrogat priori*). Presently, the amended art. 117(1) of the Constitution directly imposes limits to the central and regional legislatures which are now obliged to respect international treaty obligations. This amendment has determined a quite singular consequence in Italy. On the basis of art. 117(1), the Constitutional Court has excluded the possibility to continue to apply the *lex posterior* rule that in the past allowed treaty override. Although the Constitutional Court has not directly dealt with this topic, its position implies that transformation of international law into national law (which the Constitution still requires) has no longer effect on the possibility to override an international treaty.

In the Netherlands the effects of international treaty provisions are regulated by articles 93 and 94 of the Constitution. Art. 94 explicitly recognizes that international treaty provisions prevail over national law. This is a consequence of the fact that in the Netherlands international law has automatic effects within the national legal system. No transformation is required. ‘*International law ... has validity by virtue of its international quality. It does not have to be transformed, nor does*

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<sup>106</sup> *Foster v. Neilson*, 27 U.S. (2 Pet.) 253, 314 (1829).

*it work in the domestic legal order by virtue of an “implicit” transformation act into the “law of the land”.*<sup>107</sup>

According to article 93 of the Dutch Constitution, ‘[p]rovisions of treaties and of resolutions by international institutions, which may be binding on all persons by virtue of their contents shall become binding after they have been published.’<sup>108</sup> Therefore, only self executing treaties – after their publication – can have direct effects within the Dutch national system.

The above conducted country analysis has – in fact – showed that states regulate at discretion the relationship between national and international law and, therefore, the effects of international law within their national legal systems actually depend on the will of each individual state.

One should wonder whether the conviction of states – emphasized by Cassese – that this power falls within state sovereignty is actually founded. The answer to this question requires to focus on the conception of state sovereignty which, in turn, depends on the objective nature of international law in itself (i.e. independently from the regulation of states).

If international law can be considered objectively binding upon states, national sovereignty is limited by an international agreement which, as a consequence, cannot be unilaterally amended – i.e. its modification cannot be considered dependent on the will of states – and the rule *lex posterior abrogat priori* cannot be applied for this purpose.

#### **4. The will of states in relation to the binding effects of international treaty obligations**

Many authors, in particular at the beginning of the 20<sup>th</sup> century, did not consider it essential to individuate the source of treaty obligations. They postulated the binding nature of international treaties and did not consider it necessary to explore why, in fact, such treaties are binding on its parties. Hyde stated: “*it may be assumed that the law of nations imposes upon the parties to a treaty the duty to perform faithfully the undertakings which they have agreed to discharge.*”<sup>109 110</sup>

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<sup>107</sup> Pijl, H., *Netherlands*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 283.

<sup>108</sup> Schermers, H. G., *Netherlands* (chapter 6), in Jacobs, F. G. and Roberts, S. (editors), *The Effect of Treaties in Domestic Law – United Kingdom National Committee of Comparative Law*, United Kingdom Comparative Law Series, Volume 7, Sweet & Maxell, 1987, p. 112.

<sup>109</sup> Hyde, C.C., *International Law, Chiefly as Interpreted and Applied by the United States*, Little, Brown and co., 1922, p. 50.

<sup>110</sup> See also Harvard Draft Convention on the Law of Treaties, *Article 20 – Pacta Sunt Servanda*, in *American Journal of International Law*, Vol. 29 (1935) Supplement 977, p. 986.



In Kelsen's view *pacta sunt servanda* is the fundamental – but 'juridically undemonstrable'<sup>111</sup> – rule on which treaty obligations are founded<sup>112</sup>. This conclusion is inferred from the consideration that law is objectively binding. It is not the human will that can attribute binding character to the law. From Kelsen's point of view, legal science deals with 'ought' while sociology deals with 'is'<sup>113</sup>. It is, therefore, methodologically inadmissible to state that law originates from human will.

In an opposite view, dualists connected the binding effect of the rule *pacta sunt servanda* to the will of states.

According to the 'theory of self-limitation', the will of states is the foundation of treaty obligations.

The theory of self-limitation is the first doctrine that tries to explain the nature of international law as a 'law of co-ordination'.<sup>114</sup> Exponents of this doctrine emphasized the difference between municipal law and international law by highlighting that the first is based on subordination of citizens to the law of the state, while international law is characterized as the law of the relations between equal states. It is, therefore, highlighted the difference between the national order where 'the law of subordination' applies and the international order where the 'law of coordination' applies.

Jellinek, who is the father of the theory of self-limitation, maintained that, although international law governs the relations between coordinated and equal states, they are partially subjected to international law since its objective legal nature. It is true that it is only by virtue of their sovereignty that states can bind themselves by undertaking obligations. However, when this restriction exists and it has legally binding effects it cannot just be disregarded at discretion<sup>115</sup>.

International law has – in the view of Jellinek – a twofold nature. It involves not only legal obligations but also simple interests. Each state, being a member of the international community, has the purpose to develop a certain policy. This means that states are – in principle – obliged to respect international obligations. However, states are at the same time entitled to disregard their obligations in so far as these obligations are in contrast with their interests.

In conclusion, Jellinek recognizes the legal nature of international obligations, whose origin is the will of the individual state, but, at the same time, he affirms

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<sup>111</sup> See Harvard Draft Convention on the Law of Treaties, *Article 20 – Pacta Sunt Servanda*, in *American Journal of International Law*, Vol. 29 (1935) Supplement 977, p. 988.

<sup>112</sup> Kelsen, H., *Droit Interne et Droit International* (chapitre VI) (Les Rapports de système entre le droit interne et le droit international public, pp. 231 – 331), in 14 *Recueil des Cours*, 1926, p. 302 *et seq.*

<sup>113</sup> See also Triepel, H., '*Les rapports entre le droit interne et le droit international*', in 1 *Recueil des Cours* 1923, p. 85.

<sup>114</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, p. 417.

<sup>115</sup> Lauterpacht, H. *The Function of Law in the International Community*, Oxford University Press, 2011, pp. 417 – 418.



that the individual state has the right to breach international obligations when they are in contrast with its own interests.

According to Jellinek, this conclusion does not deprive international law of its legal nature because, in addition to its normative character, international law has also a ‘psychological foundation’, i.e. states recognize the binding effect of international law. Thus, exactly those interests that can lead states to breach international law actually confer it binding nature originating from the interest of states in their international relations<sup>116</sup>.

Many authors have criticized the theory of self-limitation<sup>117</sup>.

Lauterpacht – emphasizing the contradictory character of Jellinek’s theory which tries to combine the assumed legal and moral nature of international law – stated that ‘as a legal theory the doctrine of self-limitation cannot be interpreted otherwise than as a denial of the binding force of international law. As a sociological and psychological doctrine it amounts to a negation of the ultimate supremacy of the legally sovereign State, and thus to an affirmation of the binding force of international law.’<sup>118</sup>

Triepel considered the theory of self-limitation to be juridically inadmissible<sup>119</sup>. Similarly to Jellinek, he recognizes that the will of states is the source of the binding effects of international law. However, this is not the will of the individual state, but a common will – the so-called *Vereinbarung* (the law-making ‘agreement’), which has no contractual – i.e. synallagmatic – nature. Accordingly, since international obligations originate from a common will they certainly cannot be disregarded by virtue of the will of the individual state<sup>120</sup>.

For the same reason, Triepel described the theory which sees *pacta sunt servanda* as the fundamental – but undemonstrable – source of treaty obligations as a ‘pure fiction’<sup>121</sup>.

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<sup>116</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, p. 418.

<sup>117</sup> See Harvard Draft Convention on the Law of Treaties, *Article 20 – Pacta Sunt Servanda*, in American Journal of International Law, Vol. 29 (1935) Supplement 977, p. 987 where, amongst others, the following authors are quoted: Chailley, P., *La Nature Juridique des Traités Internationaux selon le droit contemporain*, Société anonyme du Recueil Sirey, 1932; Brierly, J.-L., *Le Fondement du Caractère Obligatoire du Droit International*, 23 Recueil des Cours (1928 – III), p. 482; Vedross, A., *Le Fondement du Droit International*, 16 Recueil des Cours (1927 – I), p. 266 *et seq.*; Triepel, H., *Droit International and Droit Interne* (Brunet trans., 1920), p. 76 *et seq.*

<sup>118</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, p. 419.

<sup>119</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, p. 423.

<sup>120</sup> Triepel, H., *Les rapports entre le droit interne et le droit international – Chapitre premiere: Distinction du droit interne et du droit international*, in Recueil des Cours, 1923, pp. 82 – 83.

<sup>121</sup> Triepel, H. *Droit International and Droit Interne* (Brunet trans., 1920), p. 62 *et seq.*; Triepel, H., ‘*Les rapports entre le droit interne et le droit international*’, in 1 Recueil des Cours 1923, p. 79 *et seq.*

Anzilotti disagrees with both the theory of self-limitation and the theory of the common will. With regard to the first theory, he considers not coherent the fact that, if international law is founded on the will of the individual State, this cannot disregard its international obligations at discretion. With regard to the theory of the common will of states, the Italian scholar asserts that the binding effect of the common will of states lacks a juridical explanation<sup>122</sup>. Thus, Anzilotti – although dualist – exactly like Kelsen, recognized the rule *pacta sunt servanda* as the juridically undemonstrable foundation of international obligations<sup>123</sup>. Significantly, Anzilotti stated: ‘*La force obligatoire de ces norms derive du principe que les Etats doivent respecter les accords conclus entre eux: pacta sunt servanda. Ce principe, précisément parce qu’il est à la base des normes don’t nous parlons, n’est pas susceptible d’une demonstration ultérieure du point de vue de ces normes elles-mêmes: il doit être pris comme une valeur objective absolue ou, en d’autres termes, comme l’hypothèse première et indémontrable à la quelle se rattache d’une façon nécessaire cet ordre, comme tout autre ordre, de connaissance humaines*’. In addition, he stated: ‘*Tout ordre juridique consiste en un complexe de normes qui tirent leur valeur obligatoire d’une norme fondamentale, à la quelle elles se ramènent toutes, directement ou indirectement. La norme fondamentale détermine, par suite, quelle sont les normes qui composent un ordre juridique donné et les ramène à l’unité. Ce qui distingue l’ordre juridique international, c’est que, dans cet ordre international, le principe pacta sunt servanda ne repose pas, comme dans le droit interne, sur une norme supérieure; c’est lui-même qui est la norme suprême*’.<sup>124</sup>

Thus, the conception according to which the *pacta sunt servanda* rule is an *a priori* assumption excludes the will of states as the foundation of the legitimacy and binding effect of international law.

## **5. States recognition and the binding effect of international law: the existence of an international community based on the principle of sovereign equality**

Lauterpacht dismisses the conception of international law as law of coordination and does not see the difference between a law of coordination and a law of subordination. International law, just as well as municipal law, derives its binding effects from a *command*, although this *command* does not stem from a national institution. This is not necessary since in Lauterpacht’s view the *Law* is objectively binding: ‘*Law may be a command without being the command of an organized*

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<sup>122</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, p. 426.

<sup>123</sup> Anzilotti, D., *Cours de Droit International*, Gidel trans., 1929, p. 42 *et seq.*; see also Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, p. 426.

<sup>124</sup> Anzilotti, D., *Cours de Droit International*, Gidel trans., 1929, pp. 43–44. See also Harvard Draft Convention on the Law of Treaties, Article 20 – *Pacta Sunt Servanda*, in American Journal of International Law, Vol. 29 (1935) Supplement 977, pp. 987 – 988.

*political authority ... law may be a command merely by virtue of its external nature [emphasis added].*<sup>125</sup>

International law is legitimate and binding upon states by its very nature.

*‘There is no reason why the original hypothesis in international law should not be that the will of the international community must be obeyed [emphasis added]. It could be said, by way of further explanation, that although in many cases the will of the international community must be deducted from the mere fact of its existence, i.e. from ‘the reason of the thing’, the organs of the formation of the will of the international community are, in the absence of an international legislature, States themselves, their consent being given by custom or treaty, and being capable of impartial ascertainment and interpretation by international tribunals [emphasis added]. An initial hypothesis expressed in the terms of voluntas civitatis maximae est servanda would point, as the source of law, to the will of the international society expressing itself in contractual agreements between its constituent members, in their customs, and in the general principles of law which no civilized community can afford to ignore; it would refer to the civitas maxima, as meaning that super-State of law which States, through the recognition of the binding force of international law qua law, have already recognized as existing over and above the national sovereignties [emphasis added]; it would be compatible with the fact that the authority of that super-State extends, so far, not so much to the creation of new concrete rules as to the maintenance and respect of obligations already expressed or contracted by implication’*<sup>126</sup>.

Lauterpacht connects the objectively binding nature of international law to the will of the international community which is not, indeed, the will of the individual state but the will as resulting from states’ consent and recognition. The will of the international community as a whole, exactly because resulting from states’ consent and recognition, becomes objective and thus able of limiting the sovereignty of the individual state. This will is formed and expressed by both customary law and international treaties<sup>127</sup>.

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<sup>125</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, pp. 427– 428.

<sup>126</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, pp. 429 – 430.

<sup>127</sup> ‘By the end of the nineteenth century ... Westlake ... saw in the fact of the existence of the international community the true basis of international law. It was stated on the very threshold of international law by Grotius : ‘haec vero ... societatis custodia, humano intellectui conveniens, fons est ejus juris, quod proprie tali nomine appellatur.’ It was expressed , by Christian Wolff, in the first scientific attempt to lay the legal foundation of the civitas maxima, when he referred to jus gentium voluntarium as being deduced not ex factis gentium, but ‘ex fine civitatis maximae quam perinde ac societatem inter omnes homines instituit ipsa natura, ut in jus istud consentire debeant gentes ...’ Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, pp. 430 – 431.

According to Tanzi, sovereign equality of states is the ‘true grund-norm’<sup>128</sup> of international law, a constitutional pillar which has shaped the whole international legal system: “Firstly, nation-states came into being *de facto*, claiming and attaining on the basis of reciprocity prerogatives and limitations that would make up the principle of sovereignty. Expectations and consequent claims of reciprocal conduct represent the meta-juridical and, at the same time, legal constituent element of the international legal community. Secondly, such sovereign actors, so self-conceived and self-perceived, would produce and utilize rules on recognition, as well as the material rules thereby produced”.<sup>129</sup>

Lauterpacht and Tanzi offer to this study the solution which is felt as the most satisfying given my conviction that starting point of any evaluation about the nature of international law and its effect within domestic legal systems is the existence of an international community created by states and where states – as also emphasized by Tanzi<sup>130</sup> – are still the main actors.

Indeed, the international community lacks a parliamentary institution and – furthermore – the jurisdiction of international tribunals is consensual<sup>131</sup>. However, states act at international level and exactly through their action – which is at the same time recognition – they have materially created rules. These rules have gradually become international law. Action has gradually become consent<sup>132</sup>.

Most importantly, as emphasized by Tanzi, states have created an international community based on sovereign equality. Gradually sovereign equality has shaped the community which appears now founded on principles completely inspired by it. In particular, the international community appears structured horizontally and, therefore, normatively founded on the equal position of each state. Consensualism is at the basis of its functioning as international organizations or the consensual jurisdiction of international tribunals show. Mostly, the entire system of the Law of Treaties either as customary law and as codified in the Vienna Convention on the Law of Treaties is founded on the principles of reciprocity, good faith and protection of legitimate expectations as corollaries of the *pacta sunt servanda* rule.

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<sup>128</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 150.

<sup>129</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 150.

<sup>130</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 145 *et seq.*

<sup>131</sup> Participation is based on consent.

<sup>132</sup> See Bernhardt, R., ‘Customary international law’, in Bernhardt, R. (editor), *Encyclopedia of Public International Law*, Amsterdam North – Holland, 1992, vol. I, pp. 898-899: ‘The international legal community is still composed of sovereign States, its organization is still rudimentary, and there is no authority with the power to enact universally binding norms. The international order has not a hierarchical but a horizontal structure; norm-creators and addressees of the norm are to a great extent identical; the subjects of international law are bound by the legal norms they themselves have enacted’.

States' consent and recognition are, therefore, at the origin of the legitimacy of international law and consequently at the origin of its binding effect upon states. Indeed, this determines the 'paradox'<sup>133</sup> of the international legal system, i.e. states create international law and are at the same time the addressees of the law they have created. As a consequence, only the 'due diligence'<sup>134</sup> of states can guarantee the enforcement of international law. But, certainly, this does not mean that states can at discretion violate international law exactly because of its objectively recognition (creation) as binding law.

This theory goes much further than the foundation of the entire international legal system on the rule *pacta sunt servanda*. First of all, this rule is no longer juridically indemonstrable but its legitimacy derives from states' recognition<sup>135</sup> and is, therefore, based on the objectively binding nature of international law. For the same reason, *pacta sunt servanda*, as an objectively binding rule of international law, does not depend on the will of states. Concretely, this means that states cannot breach an international agreement at discretion by adducing the subjective nature of the rule *pacta sunt servanda*. Indeed, the recognition of the objectively binding nature of international law strengthens the rule *pacta sunt servanda* as well. Most importantly – and as a consequence – *pacta sunt servanda* is no more at the origin of the binding effect of an international treaty. International treaties are binding in themselves on the basis of a valid agreement. The international agreement is in itself a source capable of limiting state sovereignty. After all, *pacta sunt servanda* directly concerns only the performance of an international obligation and not its origin.

## 6. Article 27 of the Vienna Convention: the content of treaty obligations as an objective limit to national law

It is well known that article 26 of the Vienna Convention – entitled “*Pacta sunt servanda*” – states that a treaty in force must be performed in good faith. Likewise, in the Preamble of the Convention it is stated that ‘*the principles of free consent and of good faith and the pacta sunt servanda rule are universally recognized*’.

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<sup>133</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 153.

<sup>134</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 169.

<sup>135</sup> ‘... This consensual or ‘positivist’ assumption is not as narrow as it might seem, for it admits that consent may take the form of a general consent to the process of customary international law, of a diffuse consensus rather than a specific consent to individual rules.’ See Byers, M., *Custom, Power and the Power of Rules – International Relations and Customary International Law*, Cambridge University Press, 1999, pp. 7– 8.

Villinger states, quoting the Harvard Draft, '*Tribunals have never questioned the validity of the principle pacta sunt servanda*'<sup>136</sup>.

There is, however, another provision of the Vienna Convention – the following art. 27 – which is extremely important for the purposes of this study.

Art. 27 states in its first sentence: '*A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty*'.

This is a customary<sup>137</sup> principle constantly held by the International Court of Justice<sup>138</sup>.

Most importantly, the Permanent Court of International Justice in the case concerning Polish nationals in Danzig<sup>139</sup> clearly stated that international treaty obligations must even prevail over constitutional provisions: '*It should ... be observed that ... a State cannot adduce as against another State its own Constitution with a view to evading obligations incumbent upon it under international law or treaties in force. Applying these principles to the present case, it results that the question of the treatment of Polish nationals or other persons of Polish origin or speech must be settled exclusively on the basis of the rules of international law and the treaty provisions in force between Poland and Danzig*'.

Art. 27 of the Vienna Convention has a central role for the purposes of the present study because it focuses – although indirectly – on the content of treaty obligations. Their content is objectively considered a limit to national law which cannot be a justification for breaching an international treaty.

Art. 27 definitively confirms the objectively binding nature of international treaty obligations. The provision at issue is the unequivocal expression of the impossibility to justify a treaty override adducing the legitimacy of the national 'mechanisms' leading to overriding results, even when international law is incorporated and transformed into national law.

Although there are no international rules which prescribe how international obligations should be implemented into the national legal systems<sup>140</sup>, states are obliged to guarantee the fulfillment of the undertaken international obligations.

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<sup>136</sup> Villinger, M. E., *Commentary on the 1969 Vienna Convention on the Law of Treaties*, Martinus Nijhoff Publishers, 2009, p. 363; Harvard Draft Convention on the Law of Treaties, Article 20 – *Pacta Sunt Servanda*, in *American Journal of International Law*, Vol. 29 (1935) Supplement 977, p. 977.

<sup>137</sup> Schaus, A., *Article 27 – Droit interne et respect des traités*, in Corten, O. – Klein, P., *Les Conventions de Vienne sur le droit des traités – Commentaire article par article*, Etablissements Emile Bruylant, S.A., 2006, pp. 1123, 1124.

<sup>138</sup> See Villinger, M. E., *Commentary on the 1969 Vienna Convention on the Law of Treaties*, Martinus Nijhoff Publishers, 2009, p. 370 and case law quoted therein.

<sup>139</sup> Permanent Court of International Justice, *Treatment of Polish Nationals and Other Persons of Polish Origin or Speech in the Danzig Territory*, Advisory Opinion of 4 February 1932, Series A/B, n°. 44, p. 24.

<sup>140</sup> Denza, E., *The Relationship between International and National Law*, in Evans, M. D. (editor) *International Law*, Oxford University Press 2006, p. 423; Wouters, J. and Vidal, M., *The International Law Perspective*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 19;

According to Malanczuk ‘... states cannot invoke their national laws and **procedures** *[emphasis added]* as a justification for not complying with their international obligations. States are required to perform their international obligations in good faith, but they are at liberty to decide on the modalities of such performance within their domestic legal systems. Similarly, there is a general duty for states to bring domestic law into conformity with obligations under international law. But international law leaves the method of achieving this result (described in the literature by varying concepts of ‘incorporation’, ‘adoption’, ‘transformation’ or ‘reception’) to the domestic jurisdiction of states. They are free to decide how best to translate their international obligations into internal law and to determine which legal status these have domestically.’<sup>141</sup>

Since there are no international rules which prescribe how international obligations should be implemented into the national legal systems, a state can, at its discretion, establish its own hierarchy of law and implement treaties through their transformation into domestic law. However, domestic legislation must comply with international treaty obligations<sup>142</sup>.

This means that a state can transform international law into national law to implement a treaty. Nevertheless, national legislation incorporating treaty provisions cannot be overridden by applying the principle *lex posterior abrogat priori*.

The application of the ‘later in time’ rule actually becomes a mechanism to assure a re-extension of state sovereignty previously limited through a valid international agreement.

To conclude, it is worth noting that the scope of art. 27 includes national judgments as well. This supports the position according to which even judicial treaty override<sup>143</sup> is not allowed under the Vienna Convention<sup>144</sup>.

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Cassese, A., *International Law*, Oxford University Press, second edition, 2005, p. 219; Steiger, H., *The Relationship of German National Law with Public International Law and the European Community Law* (chapter VI), in Vandamme, T. A. J. A. and Reestman, J. (editors), *Ambiguity in the Rule of Law. The Interface between National and International Legal Systems*, Europa Law Publishing 2001, p. 65; Malanczuk, P., *Akehurst's Modern Introduction to International Law*, Routledge, Seventh Revised Edition, 1997, p. 64.

<sup>141</sup> Malanczuk, P., *Akehurst's Modern Introduction to International Law*, Routledge, Seventh Revised Edition, 1997, p. 64. See also Ruda, J. M., *The Relationship Between International and National Law*, in Thesaurus Acroasium, Vol. XXI “East –West Relations (Legal, Economic, Political, etc. Aspects)”, Institute of International Public Law and International Relations of Thessaloniki, 1994, p. 337.

<sup>142</sup> Schaus, A., *Article 27 – Droit interne et respect des traités*, in Corten, O. – Klein, P., *Les Conventions de Vienne sur le droit des traités – Commentaire article par article*, Etablissements Emile Bruylant, S.A., 2006, pp. 1120 – 1121.

<sup>143</sup> For the distinction between legislative treaty override and judicial treaty override, see *infra* chapter I.

<sup>144</sup> Schaus, A., *Article 27 – Droit interne et respect des traités*, in Corten, O. – Klein, P., *Les Conventions de Vienne sur le droit des traités – Commentaire article par article*, Etablissements Emile Bruylant, S.A., 2006, p. 1125 that quotes PCIJ, *Case Concerning Certain German*



## 7. Legislative treaty override as a *legal injury* under the Draft Articles on State Responsibility

The International Law Commission worked for many years on the regulation of international responsibility of states. In 2001, the ‘Draft Articles on Responsibility of States for Internationally Wrongful Acts’ were adopted<sup>145</sup>. ‘*At the request of the ILC the UN GA, in its resolution 56/83 adopted in 2001, ‘took note’ of the Draft Articles and ‘commended’ them to the attention of governments ‘without prejudice to the question of their future adoption or other appropriate action.*’<sup>146</sup>

To a large extent the Draft Articles reproduce existing law. In effect, the principle that the violation of international law entails state responsibility was already accepted much earlier than the International Law Commission started to work on the Draft Articles on State Responsibility<sup>147</sup>. Already in the late twenties of the last century the Permanent Court of International Justice stated that ‘*[i]t is a principle of international law that the breach of an engagement involves an obligation to make reparation in an adequate form. Reparation therefore is the indispensable complement of a failure to apply a convention and there is no necessity for this to be stated in a convention itself.*’<sup>148</sup>

In the *Interpretation of the Peace Treaties case (Second Phase)*, the International Court of Justice stated: ‘... it is clear that refusal to fulfil a treaty obligation involves international responsibility’<sup>149</sup>

This fundamental principle of international responsibility is now clearly established by the Draft Articles on State Responsibility. Its article 1 states that ‘*every internationally wrongful act of a State entails the international responsibility of that State.*’

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*Interests in Polish Upper Silesia*, Series A, No 6, 1925. See also the Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001. Draft art. 6 establishes: ‘*The characterization of an act of a State as internationally wrongful is governed by international law. Such characterization is not affected by the characterization of the same act as lawful by internal law.*’ The relevant Commentary states that the expression ‘internal law’ also covers judicial decisions (p. 38).

<sup>145</sup> Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001, in the *Yearbook of the International Law Commission*, 2001, vol. II, Part Two. The text of the draft articles is reproduced in the Annex of a United Nations General Assembly resolution adopted on the 12<sup>th</sup> of December 2001 (A/RES/56/83).

<sup>146</sup> Cassese, A., *International Law*, Second Edition, 2005, Oxford University Press, p. 244.

<sup>147</sup> Musacchia, G., *La responsabilità internazionale degli Stati per fatti degli organi legislativi*, 1939, Industrie Grafiche L. Coluzza, 1939, p. 14.

<sup>148</sup> Permanent Court of International Justice, *Factory at Chorzów case*, Series A, No. 9, judgment No. 8, 26 July 1927, p. 21; Permanent Court of International Justice, *Factory at Chorzów case (Merits)*, Series A, No. 17, judgment No. 13, 13 September 1928, p. 29.

<sup>149</sup> International Court of Justice, *Advisory Opinion of 18 July 1950 – Interpretation of Peace Treaties with Bulgaria, Hungary and Romania (Second phase)*, p. 228.



Although the Commentary on art. 1 specifies that the term ‘*internationally wrongful act*’ corresponds to French ‘*fait internationalement illicite*’<sup>150</sup>, the concept of internationally wrongful act does not cover only delictual liability. On the contrary, the draft articles refer generally to any international obligation, regardless of its source and, indeed, also conventions or customary law.

Whereas article 1 states that international state responsibility is founded on the occurrence of an internationally wrongful act, article 2 specifies that ‘*there is an internationally wrongful act of a State when conduct consisting of an action or omission: (a) is attributable to the State under international law; and (b) constitutes a breach of an international obligation of the State.*’

Thus, article 2 of the draft articles does not mention damage as a constituent element of an internationally wrongful act.

Moreover, the Commentary to draft article 2 specifies that the need of a material or moral damage to occur in order to make state responsibility arising depends exclusively on the content of the primary obligation<sup>151</sup>. I.e., the material or moral damage is an indispensable element of state responsibility only when it is required by the primary obligation. This is confirmed by draft article 12 which specifies that ‘*there is a breach of an international obligation by a State when an act of that State is not in conformity with what is required of it by that obligation, regardless of its origin or character.*’

Since the Draft Articles on State Responsibility are based on the concept of ‘absolute responsibility’ – as it appears clear from the mentioned provisions – any breach of a treaty provision which results in an act that is not in conformity with the terms of that provision is an internationally wrongful act<sup>152</sup>.

On the basis of this qualification, tax treaty override can be considered an internationally wrongful act.

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<sup>150</sup> Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, cit., Commentary on art. 1, par. 8, p. 34; Wolfrum, R., ‘*Internationally Wrongful Acts*’, in Bernhardt, R. (editor), *Encyclopedia of Public International Law*, Amsterdam North – Holland, 1995, vol. II, p. 1399.

<sup>151</sup> Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, cit., Commentary on art. 2, par. 9, p. 36: ‘*Thus, there is no exception to the principle stated in article 2 that there are two necessary conditions for an internationally wrongful act – conduct attributable to the State under international law and the breach by that conduct of an international obligation of the State. The question is whether those two necessary conditions are also sufficient. It is sometimes said that international responsibility is not engaged by conduct of a State in disregard of its obligations unless some further element exists, in particular damage to another State. But whether such elements are required depends on the content of the primary obligation, and there is no general rule in this respect. For example, the obligation under a treaty to enact a uniform law is breached forthwith upon a failure to act on the part of the responsible State, or whether some further event must occur, depends on the content and interpretation of the primary obligation and cannot be determined in abstract.*’

<sup>152</sup> Shatabai, R., *Breach of Treaty in the Codification of the Law of State Responsibility*, Martinus Nijhoff Publishers, 2007, p. 517.

In the first chapter of this study it has been emphasized that a legislative tax treaty override is realized when national legislatures pass a law which is in conflict with a previous treaty. However, a distinction has been made between this case and the situation when a treaty override stems from a judge's interpretation which is in conflict with a previous treaty. In the following chapter it will be explained that, given the peculiar structure and functioning of the OECD Model Convention, cases of judicial tax treaty override presuppose the application of the overriding legislation for treaty purposes.

In this last case (where application of amended national law is required) there is a concrete conduct of a state directly breaching a specific treaty obligation and, therefore, determining the international responsibility of the wrongdoing state. Different is the case when treaty override originates from the sole conflict of law. Legislative treaty override represents a 'legal injury'.

The point is that a legal injury does not necessarily cause a material or moral damage. In this case, the absence of a material or moral damage requires additional consideration about the possibility that state responsibility arises according to the Draft Articles on State Responsibility.

In fact, when searching for a form of reparation for legislative treaty override it seems that – according to draft article 31 – reparation is only applicable in case a material or moral damage has been caused. Draft article 31(2) states that '*injury includes any damage, whether **material or moral** [emphasis added], caused by the internationally wrongful act of a State*'.

Furthermore, '*the provisions on restitution (Article 35) and compensation (Article 36) seem intended to make reparation for a material injury, and satisfaction (Article 37) for a moral one*'<sup>153</sup>. Thus, legal injury, which is the damage inherent to the mere violation of an international obligation and which does not necessarily cause a material or moral damage<sup>154</sup>, would seem to be excluded as a form of state responsibility.

There is, therefore, a contradiction between the first and the second part of the draft articles since, again, articles 1 and 2 only require the violation of an international obligation in order to give rise to state responsibility, whereas reparation would only be guaranteed in case of a material or moral damage.<sup>155</sup> And it is clear that without reparation, in fact, there is no responsibility.

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<sup>153</sup> Barboza, J., *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, p. 9.

<sup>154</sup> Barboza, J., *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, p. 10; Tanzi, A., *Is Damage a Distinct Condition for the Existence of an Internationally Wrongful Act?*, in Spinedi, M. and Simma, B., (editors), *United Nations Codification of State Responsibility*, Ocean Publications, Inc., 1987, p. 8.

<sup>155</sup> Barboza, J., *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, p. 9.

The question is how the first part of the Draft Articles on State Responsibility, which deals with the notion of internationally wrongful act, can be reconciled with its second part concerning the possible forms of reparation.

Barboza interpretatively connects the first and the second part of the Draft Articles on State Responsibility by arguing that the ultimate aim of the draft articles in general and of draft article 1 specifically is ‘the return to legality’<sup>156</sup>.

According to Tanzi, ‘... one can see no reason why the sole violation of an obligation (that is to say a legal damage) should not be made the object of reparation’<sup>157</sup>.

In addition, the commentary on draft article 31 makes it clear that the notion of reparation which is applicable is that established by the Permanent Court of International Justice in the representative *Factory at Chorzów* case: ‘*The essential principle contained in the actual notion of an illegal act - a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals - is that reparation must, as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed [emphasis added]*’.<sup>158</sup>

In short, this means that reparation should essentially guarantee ‘return to legality’.

The concept of ‘return to legality’ is, therefore, the basis for the recognition of legal injury as an element that is inherent to a violation of international obligations.

Both Tanzi and Barboza share the view according to which violation of international law inherently causes a breach of the legal system and, therefore, the violation of a subjective legal interest of the injured state. Although no material or moral damage is caused, the sole breach of an international obligation weakens both the international legal order<sup>159</sup> and the specific rights of the injured State<sup>160</sup>.

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<sup>156</sup> Barboza, J., *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, pp. 10, 22.

<sup>157</sup> Tanzi, A., *Is Damage a Distinct Condition for the Existence of an Internationally Wrongful Act?*, in Spinedi, M. and Simma, B., (editors), *United Nations Codification of State Responsibility*, Ocean Publications, Inc., 1987, p. 20.

<sup>158</sup> Permanent Court of International Justice, *Factory at Chorzów* case (Merits), Series A, No. 17, judgment No. 13, 13 September 1928, p. 47.

<sup>159</sup> Barboza expressly mentions the *pacta sunt servanda* rule: ‘If a contractual obligation is breached, not only the treaty establishing that obligation is adversely affected, and with it the corresponding rights of all other states parties to that treaty, but the basic norm *pacta sunt servanda* is also weakened.’ See Barboza, J., *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, p. 19.

<sup>160</sup> Barboza, J., *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, p. 10; Tanzi, A., *Is Damage a Distinct Condition for the Existence of an Internationally Wrongful Act?*, in Spinedi, M. and Simma, B., (editors), *United Nations Codification of State Responsibility*, Ocean Publications, Inc., 1987, p. 8.

The need of returning to legality allows to include ‘legal injury’ within the notion of international wrongful act<sup>161</sup>.

According to Tanzi, “*Legal damage is the result of a breach of an international obligation irrespective of the existence of either a material or a moral (stricto sensu) damage. Since to any international obligation of one State corresponds a subjective right of another, legal damage should be defined as the mere infringement of a legal right of a subject of international law. From the factual viewpoint any violation of the interest of a subject results in a damage for that subject. Since a subjective right is nothing but the legal protection given by a legal order to one’s subject’s substantive interest, any breach of such protection should entail, from the legal standpoint, the existence of a damage, irrespective of the occurrence of any further material or moral damages.*”<sup>162</sup>

It has already been highlighted above in this paragraph that the concept of international wrongful act does not cover only the French ‘*fait internationalement illicite*’ but also contractual liability. This clarification is particularly important since – notwithstanding the mentioned elucidation contained in the commentary to draft article 1 about the inadequacy of the English term ‘delict’ – contractual liability is never explicitly mentioned within the draft articles.

Since legislative treaty override is by definition the violation of international treaty provisions which is realized through the adoption of conflicting national legislation, it is clear from the above that legislative treaty override can be qualified as an internationally wrongful act according to draft articles 1 and 2, regardless of the material application of the conflicting domestic law. It is worth noting that draft article 3, in perfect accordance with article 27 of the Vienna Convention, states that ‘*the characterization of an act of a State as internationally wrongful is governed by international law. Such characterization is not affected by the characterization of the same act as lawful by internal law.*’

In particular, from Tanzi’s point of view satisfaction is the most appropriate form of reparation for legal damage. Satisfaction *inter alia* includes: the judicial declaration of the unlawful character of an act, the annulment (with *ex tunc* effects) of the act resulting in the breach of an international obligation and the payment of pecuniary damage to cover the *ex nunc* effects<sup>163</sup>.

With regard to judicial treaty override, it is highly relevant to emphasize what Tanzi wrote about the possible annulment of the wrongful act. He specified that

<sup>161</sup> For a different opinion, see Cassese, A., *International Law*, second edition, Oxford University Press, 2005, pp. 251 – 253.

<sup>162</sup> Tanzi, A., *Is Damage a Distinct Condition for the Existence of an Internationally Wrongful Act?*, in Spinedi, M. and Simma, B., (editors), *United Nations Codification of State Responsibility*, Ocean Publications, Inc., 1987, p. 8.

On the definition of ‘legal injury’, see also Barboza, J., *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, pp. 7– 8.

<sup>163</sup> Tanzi, A., *Is Damage a Distinct Condition for the Existence of an Internationally Wrongful Act?*, in Spinedi, M. and Simma, B., (editors), *United Nations Codification of State Responsibility*, Ocean Publications, Inc., 1987, p. 21.

this measure is particularly useful when the wrongdoing state adopted internal acts that conflict with international obligations<sup>164</sup>. Accordingly, Tanzi mentioned the Martini case<sup>165</sup> where the Arbitral Tribunal even ordered the annulment of a judgment of the Supreme Court of Venezuela which was considered in conflict with international obligations.

From this case it can be inferred – at least – the possibility to annul a national judgment that realizes a judicial treaty override.

## **8. Concluding remarks: the incidence of international law on tax treaty override**

A study about tax treaty override requires some preliminary essential considerations. Not only tax treaty override is – in fact – realized by some states, but in those states where it is realized it is also considered domestically legitimate by virtue of the application of the rule *lex posterior abrogat priori*. States which admit tax treaty override, generally, do not deny that tax treaty override realizes a breach of international law, but at the same time they claim their right to implement international law according to their national legal system – mostly under their constitutional provisions. This right is not denied by international law. States are, therefore, allowed to transform international law into national law. As a consequence of this transformation, an international treaty is, within the national hierarchy of sources of law, at the same level as the law incorporating the treaty. The consequence is the possibility of amending the incorporating law with a subsequent law which is on the same footing within the national hierarchy. It is exactly this ‘mechanism’ that makes it legitimate (from a national point of view) to override a treaty within some national legal systems.

Thus, one should wonder whether the legitimacy of tax treaty override at national level should lead to its legitimacy within the international legal order. There are some scholars who consider national practice the starting point in assessing the relationship between national law and international law, regardless of any theoretical approach. According to this position, the fact that tax treaty override is realized and accepted as legitimate in some states would make it legitimate at international level as well.

In literature it has also been emphasized that it is always the will of states that regulates the implementation of international law within national legal systems. Even when international law has automatic and direct effect within a national system it is always a provision – normally constitutional – of that system that allows the automatic and direct application of international law. According

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<sup>164</sup> Tanzi, A., *Is Damage a Distinct Condition for the Existence of an Internationally Wrongful Act?*, in Spinedi, M. and Simma, B., (editors), *United Nations Codification of State Responsibility*, Ocean Publications, Inc., 1987, p. 23.

<sup>165</sup> Reports of International Arbitral Awards, Vol. X, 1903, Martini Case pp. 644 – 669.

to Cassese, states have the conviction that this is a power falling within their sovereignty.

It is clear that when one recognizes that state sovereignty covers not only the procedures according to which international law should be implemented but also the effectiveness of international law within the national legal system, the binding nature of international law and the possibility to limit state sovereignty is denied.

Can be accepted that the effect of international law depends on how each state subjectively decides to regulate the relationship between national and international law within its own domestic legal system ?

The complex and multifaceted problem concerning the relationship between national and international law still covers a very wide range of solutions, today also including the first attempts to elaborate this relationship in 'global' terms<sup>166</sup>. According to my position, which is based on the theories of authoritative international scholars, there are, however, two aspects of the problem that can hardly be confuted.

Lacking a central institutional organ with parliamentary functions, states are not only the main actors, but also – and consequently – the main 'builders' of the international community. It is by means of their consent and recognition (based on their actual participation) that international law is materially created and gradually acquires legitimacy and binding force.

States are, therefore, at the origin of the objective legitimacy of international law. Furthermore, an absolutist conception of sovereignty cannot be said to characterize the present status of the international community which, on the contrary, exactly by virtue of states' consent and recognition, is founded on the principle of sovereign equality.

A valid international agreement limits the sovereignty of the parties to it. Limitation of sovereignty consequent to the conclusion of an international agreement does not allow to make the effect of international law dependent on the will of states. Thus, a discretionary re-expansion of state sovereignty through the application – although domestically legitimate – of the rule *lex posterior abrogat priori* cannot be admitted.

The contradiction that could be evidenced in this reasoning is that if states are itself the source of international law, it is evident that national practice is what states consider acceptable or not at international level.

However, this conclusion is not obvious when one considers, as authoritative scholars have emphasized, that legitimacy of international law is based on states recognition which presupposes a progressive development – firstly material and subsequently legal – of principles that have become constitutional – in a wide sense – exactly because mutually accepted.

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<sup>166</sup> Christians, A., *Sovereignty, Taxation and Social Contract*, in *Minnesota Journal of International Law*, (2009) Vol. 18, No. 1, pp. 99 – 153.

It is also clear that the existence of an international community requires its regulation. History has proved that lack of regulation leads to hegemony<sup>167</sup>. Hobbes has expressly stated that absolute freedom leads to war. Peace can only be achieved when ‘men’ mutually limit their own rights:

*‘From this Fundamental Law of Nature, by which men are commanded to endeavour Peace, is derived this second Law; That a man will be willing, when others are so too ... as for Peace, and defence of himselfe he shall think it necessary, to lay down this right to all things; and be contended with so much liberty against other men, as he would allow other men against himselfe . For as long as every man holdeth this Right, of doing any thing he liketh ; so long are all men in the condition of Warre. But if other men will not lay down their Right, as well as he; then there is no Reason for any one, to devest himselfe of his ... To lay downe a mans Right to any thing , is to devest himselfe of the Liberty, of hindring another of the benefit of his own Right to the same.’*<sup>168</sup>

What are the implications of such preliminary assessments in the present study about tax treaty override?

A first main conclusion is the qualification of tax treaty override as a violation of international law – an international wrongful act that gives rise to states responsibility – whose practice cannot be allowed on the basis of its national legitimacy. If one accepts the objective binding nature of international law, founded on its recognition by states, and, at the same time, the functional nature of international law is stated, so that international law is considered a source of legal parameters that are expressions of prescriptive judgments of values, a dichotomy between national and international law is not admissible. It cannot, therefore, be accepted the position of those states, like Germany for example, that while acknowledging that tax treaty override is a violation of international law, proclaim its admissibility on the basis of national legitimacy.

The specific qualification of legislative tax treaty override as legal injury has been based on the existence of an international legal order whose violation in itself, regardless of the existence of a material or moral damage, is not admissible and gives rise to state responsibility.

It is also clear that the concept of ‘return to legality’ on which the possibility of reparation has been founded necessarily requires the objective normative nature of international law.

The illegitimacy of tax treaty override derives by the violation of the treaty in itself and not on the breach of a rule which is external to the treaty, i.e. the rule *pacta sunt servanda*.

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<sup>167</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, pp. 154 *et seq.*

<sup>168</sup> Hobbes, T., *Leviathan*, Cambridge Texts in the History of Political Thought, ed. Quentin Skinner, Cambridge University Press, 1991, p. 92. See also Jeffery, R. J., *The Impact of State Sovereignty on Global Trade and International Taxation*, Series on International Taxation (No 23), Kluwer Law International, 1999, p. 21.



Clearly, when it is recognized that a valid international agreement is binding in itself (and not because its performance is considered mandatory under the rule *pacta sunt servanda*), not only the international treaty results reinforced but its legitimacy and binding effects depend exclusively on the treaty itself. ‘*The hypothesis pacta sunt servanda has proved a beneficent transition from a doctrine of international law based on the will of sovereign States to a doctrine of the law of nations based on the law’s impersonal sovereignty. But at present it contains the two incongruous elements. It pays homage both to the will of States as the fountain of law and to the heteronomous command of the rule of law. But the synthesis is only one of words; it is not, and cannot be, one of substance. A more satisfactory solution can be found in a hypothesis which, by courageously breaking with the traditions of a past period, incorporates the rational and ethical postulate, which is gradually becoming a fact, of international community of interests and functions ... If it is true that the initial hypothesis ought to be not a maxim with a purely formal content, but an approximation to a social value, then, indeed, the first postulated legal cause can fittingly be formulated by reference to the international community as such, and not to the will of individual States [emphasis added].*’<sup>169</sup>

The occurrence of a tax treaty override depends exclusively on the legitimacy and scope of the specifically relevant treaty. The legitimacy and scope of the rule *pacta sunt servanda*, which is external to the treaty, does not need to be evaluated. From an interpretative point of view this means that when assessing the possible realization of a case of tax treaty override, the content of the international agreement must always be the starting point in order to establish to what extent state sovereignty has been limited, regardless of the effects of the rule *pacta sunt servanda* on the specific treaty. In addition, this means that justifications to override a tax treaty will be allowed only insofar as they are established by the contracting parties through the international agreement.

To conclude, it is worth noting that the embryonic development of the Italian Constitutional Court’s case law confirms the possibility of building a system based on transformation of international law without deriving from this way of implementation the right to apply the rule *lex posterior abrogat priori*. International law does not prohibit its national implementation by way of its transformation into national law, but this cannot be assumed as an argument to legitimize – or anyway realize – tax treaty override.

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<sup>169</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, pp. 430 – 431.





## Chapter III

### ***Structure and functioning of double tax conventions: tax treaty override***

#### **1. Introduction: the purpose of defining *tax treaty override* presupposes a clear understanding of the structure and functioning of double tax conventions**

The previous chapter has demonstrated the objectively binding nature of international law as law founded on the consent and recognition of states. As a consequence, the effect of international law within national legal systems cannot depend on the will of states. Although states are allowed to transform and incorporate international law into national law, they cannot apply the rule *lex posterior abrogat priori* when its application has the concrete effect of unilaterally overriding an incorporated international treaty. Double tax conventions, therefore, limit the taxing power of each contracting state. Furthermore, the principle of sovereign equality underlies the conclusion of international agreements. Once established that the conclusion of a valid international treaty limits the sovereignty of the contracting states, the principle of reciprocity acquires a particularly important role in evaluating whether a case of treaty override has occurred. This is particularly true with respect to international treaties based on the OECD Model Convention due to their bilateral character. For the same reason and in connection with the reciprocity principle, the legitimate expectations of each contracting state necessarily have a central role when a tax treaty is interpreted. From this considerations it can be inferred<sup>1</sup>, in line with the starting point concerning the definition of tax treaty override outlined in the introduction to this study, that tax treaty override is realized when one of the contracting states – after the conclusion of a valid treaty – introduces an amendment to domestic law that unilaterally re-expands its taxing power and disrupts the taxing power allocation as originally settled within the international agreement.

Establishing whether a tax treaty override has occurred does not depend on the relationship between international and national law. This has been clarified in the previous chapter. *A fortiori*, it cannot depend on the constitutional systematization of this relationship within each national system. Starting point of an interpretative process aimed at individuating cases of tax treaty override is the international agreement.

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<sup>1</sup> The definition of tax treaty override will be progressively developed and enriched in the course of this study.

This means that when a possible case of tax treaty override is at issue the international agreement needs to be analyzed in order to exactly establish to what extent the taxing power of each contracting state has been limited. This presupposes a deep understanding of the definitively peculiar structure and functioning of the OECD Model Convention.

Therefore, this chapter exactly attempts at guaranteeing a clear and deep insight of the structure and functioning of the OECD Model Convention. The impact that the close interrelation between treaty provisions and domestic law has on the interpretation of tax treaties based on the OECD Model Convention will be examined.

## **2. Tax treaty override: structure and functioning of double tax conventions and the way they are affected by changes to domestic law**

The structure of the OECD Model Convention is somewhat peculiar because it does not establish substantive taxation rules<sup>2</sup>. Taxation is based on the law of each contracting state.

Tax treaty provisions exclusively limit the application of taxing domestic law so that double taxation or double non-taxation is avoided. In other words, tax treaties establish a complementary relationship between their provisions and domestic law so that taxes are charged under domestic law and treaty provisions have, in most of the cases, only a function of limiting taxation, i.e. the application of domestic law.

Tax treaties based on the OECD Model Convention establish a complicated (and often almost inextricable) interrelation between their provisions and domestic law. An interrelation that Jeffery has described as symbiotic<sup>3</sup>.

The functioning of the OECD Model Convention is based on a method defined of 'classification and assignment of sources'<sup>4 5</sup>.

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<sup>2</sup> Indeed, the OECD Model Convention also contains substantive provisions like, for example, art. 24 (Non-discrimination), art. 25 (Mutual agreement procedure) or art. 26 (Exchange of information).

<sup>3</sup> Jeffery, R. J., *The Impact of State Sovereignty on Global Trade and International Taxation*, Series on International Taxation (No 23), Kluwer Law International, 1999, p. 104.

<sup>4</sup> Bruins, G. W. J., Einaudi, L., Seligman, E. R. and Stamp, J. C., Report on double taxation submitted to the financial Committee of the League of Nations, League of Nations, 1923, p. 42. See also, Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 123- 124.

<sup>5</sup> See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 27 and Vogel, K. – Prokisch R. G., General Report, in *Interpretation of Double Taxation Conventions*, Cahiers de droit fiscal international, Volume LXXXVIIIa, 1993 Florence Congress, Kluwer Law and Taxation Publishers, 1993, p. 55 (English version).

The OECD Model is, therefore, based on the categorization of items of income or capital which are assigned to the contracting states.

The structure of the OECD Model is essentially based on rules which Vogel named ‘distributive rules’<sup>6</sup>. These rules not only establish which contracting state waives its tax claim<sup>7</sup>, but – more widely – they regulate the relationship between treaty provisions and domestic law in all its subjective and objective elements.

As Vogel highlighted, the distributive rules contained in double taxation agreements are not conflicts of law rules as those applicable in private international law. The OECD Model Convention’s distributive rules do not establish whether domestic or foreign law applies. Again, the functioning of double taxation conventions is always based on the application of domestic law and, accordingly, the distributive rules contained in tax treaties can preferably be considered ‘**rules of limitation of law**’<sup>8</sup>.

Considering the wide scope of each distributive rule, Vogel stated that the conception considering tax treaties aimed at solving cases of conflicting jurisdiction is ‘obsolete’<sup>9</sup>.

Significantly, Vogel stated : ‘... DTCs establish an independent mechanism to avoid double taxation through restriction of tax claims in areas where overlapping tax claims are expected, or at least theoretically possible. In other words, the contracting States mutually bind themselves not to levy taxes, or to tax only to a limited extent, in cases when the treaty reserves taxation for the other contracting state either entirely or in part. Contracting States are said to ‘waive’ tax claims ... or more illustratively to divide ‘tax sources’, ‘the taxable objects’ (Steuergut) among themselves ...’<sup>10</sup>

The OECD Model Convention establishes a delicate balance between those aspects concerning limitation of taxation that fall within the scope of the treaty and those aspects concerning taxation that continue to pertain to state sovereignty. This mainly depends on the fact that in most of the cases the application of distributive rules is based on a domestic law qualification of income or capital. As Garbarino highlighted, ‘an interpretation of tax treaties that leaves completely aside domestic law is not possible in concrete. Tax treaties complete and presuppose domestic law ...’<sup>11</sup>.

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<sup>6</sup> See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 27.

<sup>7</sup> See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, pp. 26 –27.

<sup>8</sup> See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 20.

<sup>9</sup> See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 26.

<sup>10</sup> See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, pp. 26 –27.

<sup>11</sup> Garbarino, C., *Manuale di tassazione internazionale*, IPSOA Wolters Kluwer Italia, II edition, 2008, p. 194: ‘... un’interpretazione delle Convenzioni contro le doppie

This functioning of domestic law in a way that it substantially completes tax treaty provisions allows a certain leeway in the exercise of national sovereignty. The identification of these limits requires a complex process of interpretation. This interpretative process should exactly analyze how the relationship between treaty provisions and domestic law has been regulated in each specific provision at issue. In other words, identifying a case of tax treaty override presupposes to individuate exactly the terms and the conditions of the agreement in order to establish whether and to what extent domestic law applies and can be possibly amended without exceeding the limits established by the treaty .

Thus, the difficulty about this intricate interrelation between treaty provisions and domestic law consists of assessing the extent to which the sovereignty of the contracting states has remained unaltered so that it could still include the possibility of amendments posterior to the conclusion of the treaty.

Sinclair stated: ‘ ... the object and purpose of a bilateral tax treaty is not to unify or harmonise the laws of the two States concerned; it is rather to provide relief from tax in that State which would or might otherwise charge it. **There is, therefore, an intimate connection between the relieving provisions and the charging provisions of internal law ... [emphasis added]**’<sup>12</sup>

The core of the problem with tax treaty override is exactly that the scope of the domestic charging provisions cannot be unilaterally extended so that it becomes wider than the scope of the treaty relieving provisions.

Therefore, it is exactly this ‘intimate’ connection between the treaty relieving provisions and the charging provisions of internal law which needs to be identified and analyzed in order to establish whether a case of tax treaty override has occurred.

The interpretative process aimed at individuating a case of tax treaty override should – in essence – define the delicate (and ‘intimate’) balance between the treaty relieving provisions and the domestic taxing provisions that is established through the relevant distributive rule.

Treaty override exists when internal law is unilaterally modified in conflict with one or more elements of the applicable distributive rule (those elements that have been ruled by the treaty and do not, therefore, fall within the contracting state sovereignty any longer) and, as a consequence of this change, the taxing jurisdiction of the contracting state results to have been extended exceeding the limits established by the relevant(s) distributive rule(s) (therefore, in conflict with the common intention of the parties).

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imposizioni che prescindano totalmente dalla legislazione interna non é attuabile in concreto. Le Convenzioni fiscali completano e presuppongono le legislazioni nazionali ...’. English translation of the present author.

<sup>12</sup> Avery Jones, J. E., *Interpretation of Tax Treaties*, in Bulletin for International Fiscal Documentation, Vol. 40 (1986), No. 1, p. 77. [Author’s note: This article is the transcription by Mr Avery Jones of seminar B at the IFA Congress held in London in 1985].

This approach seems to be supported by Vogel, when he states: ‘*Within the scope of a treaty ... a tax obligation exists only if and to the extent that, in addition to the requirements of domestic law, the treaty requirements also are satisfied*’.<sup>13</sup>

This shows that any evaluation about the exact relationship between domestic taxing law and treaty provisions requires an extensive analysis of all the elements building a distributive rule so that the interrelation between international and national provisions is rigorously identified. It is exactly this interrelation that creates the limits to the application of amended domestic law.

The central role of each distributive rule in examining the possible cases of tax treaty override depends exactly on the fact that the OECD Model Convention is characterized by rules individually related to specific items of income or capital. These rules enucleate all the relevant elements concerning the limitation of taxation of that particular item of income or capital, also with reference to the role that each legal source can have in the application of treaty provisions and domestic law. This discloses the intrinsic contradiction of the OECD Model Convention: the attempt to create a unitary system through the interrelation of differently sourced law. On the one hand the treaty provisions that have consensual origin and on the other hand the domestic legislation that has national origin and, therefore, from an international point of view – is unilaterally established. Treaty provisions have the function to limit national provisions. Indeed, this has its clear rationale. Treaty provisions represent the common intention of the parties and naturally limit the taxing power of each contracting state. Nevertheless, not only the limits established by the OECD Model Convention are necessarily liable but their evaluation is also completely up to each contracting state.

This consideration allows to draw an important conclusion. Since treaty provisions have the function to limit the domestic taxing legislation, the treaty is the starting point to evaluate whether a case of tax treaty override has occurred. In particular, the interpretative process regarding the relationship between treaty provisions and domestic tax law should start with the exact (as long as possible) identification of the limits established by the treaty provisions which, in turn, should be interpreted according to the relevant articles of the Vienna Convention on the Law of Treaties in addition to the specific interpretative rules of the relevant treaty.

Domestic law applies to the extent and according to the conditions established by the provisions of the relevant tax treaty<sup>14</sup>.

This is a really important point. Once established – as it has been established in the second chapter of the present study – that international law limits national sovereignty, it is the treaty – the agreement between the parties – that determines the extent to which national law can be applied. This is always true unless

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<sup>13</sup> See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 20.

<sup>14</sup> Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 20, 26.

justifications to a breach of a treaty are accepted. This is specifically the topic regarding the relationship between treaty provisions and national anti-abuse rules which will be analyzed in the sixth chapter of this study.

However, as a general rule, since tax treaties are structured so that they limit national taxing law, evaluating when these limits have been exceeded by a contracting state necessarily implies to individuate which limits the contracting states have agreed upon. And since these limits are established through the tax treaty, its provisions are, indeed, the point of reference within the interpretative process aimed at individuating cases of tax treaty override.

### **3. The moment when a tax treaty override actually occurs: legislative and judicial tax treaty override**

Before starting to analyze, in the following chapters, the interpretative process that can lead to the individuation of cases of tax treaty override, another preliminary aspect needs to be examined. This is the moment that a tax treaty override actually occurs.

As clarified in the introduction of this study, treaty override is, by definition, a conflict between international treaty provisions and subsequently adopted national law. It is clear that this conflict can exist only to the extent that the conflicting provisions have the same scope.

This aspect is particularly relevant with regard to *tax* treaty override because of the peculiar structure of tax treaties based on the OECD Model Convention. As already emphasized above in this chapter, the functioning of double taxation conventions is based on the application of domestic law which completes each distributive rules. It is clear that the conclusion of an international treaty cannot limit state sovereignty with regard to the adoption or amendment of domestic law which is, in principle, destined to apply for domestic purposes exclusively or, possibly, also as unilateral measures against double taxation. Nevertheless, state sovereignty is limited with regard to the right to *apply* domestic law for tax treaty purposes. This has a really important consequence for our purposes. Tax treaty override mostly occurs only when domestic law is *applied* for treaty purposes, regardless of its adoption. Thus, in most of the cases, tax treaty override will have the form of a judicial treaty override. Legislative treaty override will be actually possible only when the scope of the new domestic legislation exclusively coincides with the scope of the relevant tax treaty. This will be mostly possible when domestic law expresses the legislature's intention to override existing tax treaties<sup>15</sup>.

According to the 1989 OECD Report on treaty override, the moment when a treaty override occurs coincides with the adoption of the new conflicting domestic law, regardless of its application. This depends on the fact that, from the

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<sup>15</sup> For the difference between legislative and judicial treaty override see *infra* chapter I.

OECD's point of view, treaty override can occur only when the new amended law expresses the legislature's intention to override existing tax treaties<sup>16</sup>. In the 1989 Report there is no mention of the above clarification about the functioning of the OECD Model Convention that often requires the application of domestic law for treaty purposes. In this case, indeed, domestic law needs to comply with the relevant treaty. Consequently to its position, the OECD excludes that a treaty override can derive from art. 3(2) of the OECD Model Convention. The reason is exactly that the contracting states sovereignty is not affected with regard to the modification of national definitions<sup>17</sup>. In the following chapter it will be argued that tax treaty override can occur also in connection with art. 3(2) because it is a general interpretative clause that requires the application of domestic definitions for treaty purposes. As a consequence, a treaty override occurs when amended domestic definitions, which in principle are adopted for internal purposes only (or as unilateral measures against double taxation), are applied in contrast with the limits established by the relevant treaty and its context.

#### **4. Concluding remarks: the impact of the functioning and structure of the OECD Model Convention on tax treaty override**

This chapter has the function to connect the part of this study where treaty override has been analyzed from a general international law perspective with the following part more specifically dedicated to tax treaty override.

In the second chapter a fundamental conclusion has been reached. International agreements are governed by the principle of sovereign equality. This means that when states conclude a valid international agreement their sovereignty is limited on the basis of reciprocal obligations and unilateral amendments are not admissible. Through *consent* and *recognition* states have legitimized the principle of sovereign equality and excluded an absolute conception of state sovereignty. The application of these conclusions to tax treaties based on the OECD Model Convention needs to be evaluated first of all in the light of the OECD Model structure and functioning. Tax treaties are mostly characterized by distributive rules which limit the application of substantive national tax law. The extent to which the national taxing power has been limited defines at the same time the limits to the contracting state sovereignty. When these limits are exceeded a tax treaty override is realized. The scope of the domestic charging provision cannot be unilaterally extended so that it exceeds the scope of the treaty relieving provision.

This chapter has emphasized the symbiotic interrelation between tax treaty provisions and domestic law. This interrelation has a decisive impact on the

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<sup>16</sup> OECD, *Tax Treaty Override*, OECD 1989, p. 6.

<sup>17</sup> OECD, *Tax Treaty Override*, OECD 1989, p. 6.



interpretative process aimed at individuating cases of tax treaty override. The exact balance between treaty provisions and domestic law – as established within each distributive rule – needs to be individuated. This interpretative process will be delineated in the following chapters of this study. In parallel, the elements characterizing a tax treaty override will emerge.

From the first chapter it was already clear that tax treaty override stems from a conflict between treaty provision(s) and subsequent domestic law. The outcomes of the second chapter have led to point out that a tax treaty override directly affects the allocation of the taxing power as agreed upon between the contracting states. A tax treaty override is realized when a contracting state unilaterally re-extends its taxing power. It has also been highlighted that there is no unanimity of positions about the moment when treaty override is realized, i.e. when domestic law is passed or when it is applied<sup>18</sup>. The adoption of conflicting domestic law can automatically determine a case of treaty override when the scope of domestic legislation coincides exactly with the scope of the unilaterally amended treaty provision(s). In this case a legislative treaty override occurs and it is often realized through the express intention to override existing tax treaties. However, tax treaties are based on the application of domestic law which, in most of the cases, is not specifically adopted for treaty purposes. In this case, indeed, state sovereignty cannot be considered limited in order to amend this domestic legislation. However, the relevant tax treaty can limit the right of the contracting states to *apply* amended domestic law which is in conflict with a previously concluded tax treaty. This means that in most of the cases tax treaty override will occur only at the moment when amended domestic law is applied for tax treaty purposes. As a consequence, tax treaty override is often realized judicially<sup>19</sup>. This aspect will be further analyzed in the following chapter.

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<sup>18</sup> See *infra*, chapter I.

<sup>19</sup> For the distinction between legislative treaty override and judicially treaty override see *infra*, chapter I.

## Chapter IV

### *Interpretation of the international agreement: the occurrence and scope of tax treaty override*

#### **1. Introduction. Art. 3(2) and exit taxation: two important subject-matters in order to analyze some of the constituent elements of tax treaty override**

This chapter mainly focuses on the central role that interpretation has not only in order to detect cases of tax treaty override but also in order to determine their exact scope. Part A of this chapter will be dedicated to art. 3(2) of the OECD Model Convention. Art. 3(2) is a general interpretative clause that has a central role within the OECD Model Convention since it connects – through the application of national definitions – the treaty relieving provisions with domestic tax legislation. Domestic law can be applied to the extent that the treaty context does not require otherwise. The treaty context has, therefore, the function of limiting the application of domestic law in order to avoid that the scope of domestic tax law becomes wider than the scope of the treaty relieving provisions. Since interpretation is essential in this process, this chapter starts with a study of the scope and functioning of art. 3(2). Only when the scope and functioning of this article is understood in an exact way, it will be possible to determine the right balance between domestic definitions and treaty context. In turn, this will permit to understand the relationship (and to find the balance) between the treaty relieving provisions and domestic tax legislation. This interpretative process will involve also fictitious definitions. Their compliance with the OECD Model Convention will be evaluated at the end of part A of this chapter. This analysis concerning fictions will continue in part B which will specifically deal with exit taxation. This is a particularly delicate matter. Exit taxation is not contemplated by the OECD Model Convention. The right of the state of source to tax income accrued during the period of residence of the emigrant taxpayer (and not yet realized at the moment of emigration) is not protected by the OECD Model Convention.

When can an exit tax regime be considered compliant with the OECD Model Convention? How to assure a solution which is compliant with the OECD Model Convention in order to guarantee taxation to the state of source in case of transfer? These issues will be examined in part B of this chapter through the analysis of the case law of the Dutch Supreme Court concerning exit taxation. However, this analysis will continue in chapter 6 when the then developed ‘interpretative model’ will be applied to the newly introduced U.S. exit tax regime as well as to the UK ‘re-entry charge’.

**PART A - Article 3(2) of the OECD Model Convention: the importance of defining its scope and functioning in order to establish whether cases of tax treaty override have occurred**

**1. Introduction: the occurrence and scope of tax treaty override defined on the basis of the interpretation of the relevant international agreement**

The second chapter of this study has demonstrated that the occurrence and scope of tax treaty override cannot depend on the national legislation that regulates the relationship between national and international law and, therefore, on the interpretation of this legislation in accordance with domestic hermeneutic rules. This is a consequence of the fact that an international agreement has objectively binding effects upon states, i.e. it limits state sovereignty and, therefore, the taxing power of the contracting states. A tax treaty override is realized when one of the contracting states – after the conclusion of a valid treaty – introduces an amendment to domestic law that unilaterally re-expands its taxing power and disrupts the taxing power allocation as originally established within the international agreement. Thus, the occurrence and scope of tax treaty override exclusively depends on the interpretation of the relevant international agreement according to international hermeneutic rules.

The third chapter has showed that the interpretation of a tax treaty is strongly influenced by the peculiar structure of the OECD Model Convention. This is because the functioning of the OECD Model Convention is based on an integrated application of treaty provisions and domestic law. While taxes are charged under substantive domestic law, double taxation is avoided through the application of formal distributive rules that limit the application of domestic law. Interpreting a tax treaty – in order to detect cases of tax treaty override – means to individuate the extent to which the formal treaty provisions – i.e. the distributive rules – have limited the application of the domestic tax provisions. Art. 3(2) of the OECD Model Convention has a very significant role in this process of interpretation. It states: *‘As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies ...’*<sup>1</sup>

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<sup>1</sup> The 2006 U.S. Model Tax Convention contains substantially the same provision. The only difference is that the U.S. Model refers explicitly to the possibility of a mutual agreement procedure. Art. 3(2) of the U.S. Model Convention literally states: *‘As regards the application of the Convention at any time by a Contracting State any term not defined therein shall, unless the context otherwise requires, or the competent authorities agree to a common meaning pursuant to the provisions of Article 25 (Mutual Agreement Procedure), have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.’*

Art. 3(2) is a general<sup>2</sup> interpretative clause that exactly reflects the structure and functioning of the OECD Model Convention. The provision at issue establishes the application of domestic definitions when a term<sup>3</sup> which is used within the relevant tax treaty is not defined therein. Art. 3(2) determines the application of national law for treaty purposes. Domestic definitions become an integral part of the international agreement. As a consequence, the amendment of these definitions and their application for treaty purposes are subjected to the limits established by the treaty and its context through the provision ‘unless the context otherwise requires’. The interpretation of this last provision is, therefore, essential in order to establish the balance between domestic law and treaty provisions.

Through the interpretation of art. 3(2) this chapter will first of all establish whether a case of tax treaty override can occur when a domestic definition is amended and applied for treaty purposes and the limits established by the treaty context (‘unless the context otherwise requires’) are exceeded. This analysis necessarily involves also an examination of the consequences of a so-called ambulatory interpretation that art. 3(2) allows. This means that domestic definitions are applicable with the meaning they have at the moment the international treaty is applied even if these definitions have been amended after the conclusion of the treaty. It is clear that the ambulatory interpretation realizes a partial derogation from both art. 26 of the Vienna Convention – that establishes the *pacta sunt servanda* rule – and the following art 27 according to which breaches of international treaties cannot be justified in the light of national law. Indeed, the amendment of a definition after the conclusion of a treaty and its application for treaty purposes partially override the relevant international agreement (the agreement is unilaterally modified). However, to the extent that the ambulatory interpretation does not exceed the limits established by the context this modification is allowed by art. 3(2) itself. In this case there is a treaty override but it is admissible and therefore legitimate.

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<sup>2</sup> See Paragraph 11 of the OECD Commentary on article 3. It states literally: ‘*This paragraph provides a general rule of interpretation for terms used in the Convention but not defined therein.*’

<sup>3</sup> It is accepted that ‘term’ in the provision at issue refers not only to individual words but also to ‘group of words’: see Vogel, K. – Prokisch R. G., General Report, in *Interpretation of Double Taxation Conventions*, Cahiers de droit fiscal international, Volume LXXXVIII, 1993 Florence Congress, Kluwer Law and Taxation Publishers, 1993, p. 79 (English version). Ward and his co-authors quote the Oxford English Dictionary and write: ‘*The Oxford English Dictionary defines “term”, in relevant part, as “a word or phrase used in a definite or precise sense in some particular subject, as a science or art; a technical expression ... in wider application: any word or group of words expressing a notion or conception, or denoting an object or thought; an expression (for something).”*’: see Ward, D. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IBFD Publications BV, 2005, p. 20, footnote No. 44. See also Kandev, M. N., *Tax Treaty Interpretation: Determining Domestic Meaning Under Article 3(2) of the OECD Model*, In Canadian Tax Journal, Vol. 55 (2007), No. 1, p. 40.

## 2. An historical introduction to understand the role and functioning of art. 3(2) within the OECD Model Convention

A deeper understanding of the structure and functioning of art. 3(2) of the OECD Model Convention presupposes to analyze its historical background, although the literature on the topic is extremely limited as a consequence of the very few relevant documents available.

Already in 1923, the Report On Double Taxation elaborated for the League of Nations stated : *‘[w]e have already indicated that the economic conception of income is so complex and that the legal and statutory definitions of income by different countries are so diverse that the problem of double taxation is much more seriously complicated for this class of taxes than for any other.’*<sup>4</sup> Consequently, the four prominent authors excluded the practicability – although they considered it the soundest solution in theory – of a method to avoid double taxation based on ‘classification and assignment of sources’<sup>5 6</sup>. The problem, which was considered from a strict economic point of view (‘economic allegiance’) was essentially to individuate the exact source of income in each country and – consequently – to determine the exact amount of income in each country.

The first League of Nations Drafts followed this position. Avery Jones reports that while the 1943 Mexico Draft defined ‘income from immovable capital’ only,

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<sup>4</sup> Bruins, G. W. J., Einaudi, L., Seligman, E. R. and Stamp, J. C., Report on double taxation submitted to the financial Committee of the League of Nations, League of Nations, 1923, p. 45.

<sup>5</sup> Bruins, G. W. J., Einaudi, L., Seligman, E. R. and Stamp, J. C., Report on double taxation submitted to the financial Committee of the League of Nations, League of Nations, 1923, p. 45. Notoriously the authors of the report were in favour of a “*method of exemption for income going abroad*”. See op. cit. p. 42; p. 48 *et seq.*

<sup>6</sup> The four prominent Reporters describe the method of classification and assignment of sources as follows ‘*By Convention it might be determined to attach origin taxation specifically and wholly to particular classes of investments or embodiments of wealth, such as rents of land and of houses and mortgages on real property, but to exempt the non-resident in respect of income derived from business securities. The country of residence would allow the whole of the foreign tax as a deduction from its income tax on the resident in respect of such sources of income, but would charge other sources in full. It would be necessary to give the country of residence complete power of charging all sources except for certain specified exceptions , so that the scope of its liability to remit the tax would be easily determined, and the investor, from his total income-tax demands, would be able to deduct certain specified taxes on any real property he might have . It might be desirable to impose some limit upon the power of the country of origin to levy in future specially heavy specific origin taxes, which would unduly deplete the exchequer of the country of residence. This may be called the method of classification and assignment of sources.*’ See Bruins, G. W. J., Einaudi, L., Seligman, E. R. and Stamp, J. C., Report on double taxation submitted to the financial Committee of the League of Nations, League of Nations, 1923, p. 42.

the following 1946 London Draft excluded any qualification of income from its text<sup>7</sup>.

Opposite was the contemporary approach of the United States whose treaties were structured on common definitions of items of income. Thus, as Avery Jones states, the treaty concluded between USA and Canada in 1942 ‘contained definitions of: rentals and royalties, interest, dividends, pensions and life annuities’<sup>8</sup>.

Avery Jones highlights that there are no documents available that explain or permit to understand why the approach of common definitions was abandoned<sup>9</sup>. The British author is of the opinion that at a certain point it must have been clear that this approach could not work in practice because it could never lead to exhaustive results<sup>10</sup>.

In addition, according to Avery Jones, states ran into the problem of the diversity of the tax systems when common law states started to conclude tax treaties with states of civil law whose tax systems were based on *impôts réel*<sup>11</sup>. According to Avery Jones, the problem of the inevitable lacks of definitions became even more evident since countries could no more count on the application of a similar domestic definition in case such a definition was missing in the relevant treaty provision<sup>12</sup>.

A provision substantially correspondent to art. 3(2) has been used for the first time in 1945 when the income tax and estate tax treaties between the United States and the United Kingdom were signed<sup>13</sup>. The Anglo-Saxon origin of the

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<sup>7</sup> Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, Guglielmo (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 124.

<sup>8</sup> Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, Guglielmo (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 124.

<sup>9</sup> Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, Guglielmo (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 124.

<sup>10</sup> Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, Guglielmo (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 124.

<sup>11</sup> Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, Guglielmo (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 125.

<sup>12</sup> Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, Guglielmo (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 125.

<sup>13</sup> Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, Guglielmo (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 124; Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 18; Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 209.

provision is also evident from its wording, which – as it will be highlighted below – uses the typical British clause ‘unless the context otherwise requires’.

Vogel suggests that the provision must mainly have had the purpose to protect each contracting state sovereignty<sup>14</sup>.

After 1945, a provision substantially coincident with that contained in art. 3(2) was consistently introduced in double taxation agreements of common law countries as well as within the agreements concluded between common law and civil law countries<sup>15</sup>.

When the 1963 OECD Draft Model was elaborated, Working Party No. 14 was in charge of the ‘Article on Definitions’.

The first version of the Draft Article was presented in 1959<sup>16</sup>. Interestingly, the relevant Report in its introductory part states:

*‘1. At its 9th Session in September, 1958, the Fiscal Committee of the O.E.E.C. set up the Working Party N° 14, composed of the Delegations of Austria and Sweden, to prepare several provisions of a general nature which should be inserted in Conventions for the avoidance of double taxation.*

*2. In drafting the following articles, the Working Party had to take into consideration not only provisions of an identical or similar character contained in Conventions concluded between O.E.E.C. Member countries but also the provisions of draft articles already adopted by the Fiscal Committee or being prepared by other Working Parties.*

...

*3. Provisionally, the present draft articles are prepared for the purposes of bilateral conventions.’*

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<sup>14</sup> Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 209.

<sup>15</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 18. The authors specify that the provision was still not always included within tax treaties concluded between civil law countries (See pp. 18-19).

<sup>16</sup> Working Party No 14 of the Fiscal Committee (Austria – Sweden) – Report of general provisions to be inserted in Conventions for the avoidance of double taxation (Received on 25<sup>th</sup> February, 1959), Paris, 3rd March, 1959, available at [www.taxtreatieshistory.org](http://www.taxtreatieshistory.org). The website ‘*History of Tax Treaties*’ is, as therein indicated, a joint project of the OECD, Institute for Austrian and International Tax Law Vienna (WU), IBFD, Università Cattolica del Sacro Cuore, IFA Canadian Branch and the Canadian Tax Foundation on the history of tax treaties and their provisions.

Thus, paragraph 2 of draft Article “D” was proposed in a version already substantially coincident with the present art. 3(2) <sup>17</sup>. It was the version that had already been used since 1945<sup>18</sup>.

Interestingly, the relevant Commentary, which was presented in the same 1959 Report, in connection with the above reported introduction, stated: “9. *The rule of interpretation laid down in paragraph 2 corresponds to similar provisions normally appearing in double taxation Conventions. The rule of interpretation in paragraph 2 of the Article on the taxation of income from immovable property, which has to be regarded as “lex specialis”, will in no way be affected by that present general rule of interpretation*”. The discussion about the second paragraph of the provision at issue was extremely limited. In the Minutes of the 2nd Session held in January 1962 it is stated: ‘*Concerning the second paragraph of the draft Article on definitions, the Delegate for Germany pointed out that there might be conflicting definitions in different domestic statutes for the terms which were not defined in the Article. The Committee agreed that the Commentary should state that such cases would be settled by the mutual agreement procedure.*’<sup>19</sup>

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#### ARTICLE D

(1) In the present Convention, unless the context otherwise requires :

- a) The term “person” comprises an individual and any body of persons, corporate or not corporate;
- b) The term “company” means any body corporate and any entity which is treated as a body corporate for tax purposes;
- c) The terms “enterprise of one of the Contracting States” or “enterprise of the other Contracting State” mean an enterprise carried on by a resident of one or the other Contracting State;
- d) The term “competent authorities” means :
  - i) in the Contracting State A .....
  - ii) in the Contracting State B .....

(2) As regard the application of the present Convention by one of the Contracting States any term not otherwise defined shall, unless the context otherwise requires, have the meaning which the term has under its own tax laws.

See Working Party No 14 of the Fiscal Committee (Austria – Sweden) – Report of general provisions to be inserted in Conventions for the avoidance of double taxation (Received on 25<sup>th</sup> February, 1959), Paris, 3rd March, 1959, available at [www.taxtreatieshistory.org](http://www.taxtreatieshistory.org). The website ‘*History of Tax Treaties*’ is, as therein indicated, a joint project of the OECD, Institute for Austrian and International Tax Law Vienna (WU), IBFD, Università Cattolica del Sacro Cuore, IFA Canadian Branch and the Canadian Tax Foundation on the history of tax treaties and their provisions.

<sup>18</sup> Avery Jones specifies that the article introduced in the 1963 OECD Draft Model Convention was ‘virtually identical’ to the version firstly used in 1945 within the income tax and estate tax treaties between the United States and the United Kingdom. See Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 18.

<sup>19</sup> Fiscal Committee, Minutes of the 2<sup>nd</sup> Session held at the Château de la Muette, Paris, on Tuesday, 16<sup>th</sup>, Wednesday 17<sup>th</sup>, Thursday 18<sup>th</sup> and Friday 19<sup>th</sup> January, 1962, Paris, 19th February, 1962, available at [www.taxtreatieshistory.org](http://www.taxtreatieshistory.org). The website ‘*History of Tax Treaties*’ is, as therein indicated, a joint project of the OECD, Institute for Austrian and



In February 1962 the text of the article was elaborated in its final version. The Final Report includes the text of the Commentary as well. Both the provision at issue and its Commentary remained substantially unaltered from the 1959 first draft version<sup>20</sup>.

### 3. Explaining the rationale of art. 3(2) of the OECD Model

#### **Convention: the correspondence between treaty relieving provisions and domestic tax provisions**

The present version of art. 3(2) of the OECD Model Convention establishes: *‘As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies ...’*.

According to its wording, art. 3(2) of the OECD Model Convention is a mandatory provision. It *‘shall’* be applied every time an undefined treaty term needs to be interpreted. At the same time, it applies only in order to interpret terms that are used in the treaty but are not defined within it. This means that art. 3(2) does not establish a general *renvoi* to domestic law. Under art. 3(2) national legislation cannot be generally applied to fill the gaps of a tax treaty<sup>21</sup>.

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International Tax Law Vienna (WU), IBFD, Università Cattolica del Sacro Cuore, IFA Canadian Branch and the Canadian Tax Foundation on the history of tax treaties and their provisions.

<sup>20</sup> Text of the Article:

“2. As regards the application of the present Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of the present Convention”.

Commentary:

“Paragraph (2):

9. The rule of interpretation laid down in paragraph 2 corresponds to similar provisions normally appearing in double taxation Conventions. The rule of interpretation in paragraph 2 of Article XIII on the taxation of income from immovable property, which has to be regarded as “*lex specialis*” is in no way affected by the present general rule of interpretation.”

See Working Party No 14 of the Fiscal Committee (Austria – Sweden) – Final Report concerning the articles on definitions, diplomatic and consular privileges, entry into force and denunciation of the Convention (Received on 26<sup>th</sup> February, 1962), Paris, 28th February, 1962, available at [www.taxtreatieshistory.org](http://www.taxtreatieshistory.org). The website ‘*History of Tax Treaties*’ is, as therein indicated, a joint project of the OECD, Institute for Austrian and International Tax Law Vienna (WU), IBFD, Università Cattolica del Sacro Cuore, IFA Canadian Branch and the Canadian Tax Foundation on the history of tax treaties and their provisions.

<sup>21</sup> Shannon notes: *‘The rule of interpretation of Article 3(2) refers to domestic law. However, it is not a general reference to domestic law for all doubtful treaty issues; its scope is much more limited.*

Vogel specifies that the provision at issue is a general rule of interpretation in respect to the other more specific rules of interpretation of the OECD Model Convention, but it is *lex specialis* in respect to the rules of interpretation established by the Vienna Convention on the Law of Treaties<sup>22 23</sup>.

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*Article 3(2) governs only the interpretation of terms used, but not defined, in the treaty. It does not provide a basis for relying on general principles of domestic law to interpret the treaty, and it does not provide a mechanism to fill all gaps in the treaty.* See Shannon, H. A., *United States income tax treaties: Reference to domestic law for the meaning of undefined terms*, in Intertax, Vol. 17 (1989), No. 11, p. 455. See also Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 42.

- <sup>22</sup> Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, pp. 209, 211. About the nature of *lex specialis* of art. 3(2) of the OECD Model Convention see also Engelen, F. A., *Interpretation of Tax Treaties under International Law - A study of Articles 31, 32 and 33 of the Vienna Convention on the Law of Treaties and their application to tax treaties*, IBFD Doctoral Series Vol. 7, IBFD Publications, 2004, p. 478 *et seq.*; Wattel, P. J – Marres, O., *Characterization of Fictitious Income under OECD-Patterned Tax Treaties*, in European Taxation, vol. 43 (2003), No. 3, p. 66; Shannon, H. A., *United States income tax treaties: Reference to domestic law for the meaning of undefined terms*, in Intertax, Vol. 17 (1989), No. 11, p. 455.

It is also important to say that there are different opinions on the relationship between art. 3(2) of the OECD Model Convention and the interpretative provisions of the Vienna Convention. About this debate see, for example, Kandev, M. N., *Tax Treaty Interpretation: Determining Domestic Meaning Under Article 3(2) of the OECD Model*, in Canadian Tax Journal, Vol. 55 (2007), No. 1, p. 38–39. Kandev, however, specifies that “[t]he prevailing view today seems to be that art. 3(2) is a special rule in relation to VCLT articles 31 and 32 and thus takes precedence over those general rules.” (op. cit., p. 39); See also Van der Bruggen, E., *Unless the Vienna Convention Otherwise Requires: Notes on the Relationship between Article 3(2) of the OECD Model Tax Convention and Articles 31 and 32 of the Vienna Convention on the Law of Treaties*, in European Taxation, Vol. 43 (2003), No 5, pp. 142 – 143.

- <sup>23</sup> It is important to highlight that also the provisions concerning interpretation of international treaties – and not only those concerning their conclusion, as it was explained in the second chapter of the present work – are rules of customary law. Thus, articles 31, 32 and 33 of the Vienna Convention are applicable even to those states that are not parties to the Vienna Convention or have not yet ratified it. See, ex multis, Lang, M. and Brugger, F., *The role of the OECD Commentary in tax treaty interpretation*, in Australian Tax Forum, Vol. 23 (2008), p. 97; Erasmus – Koen, M. and Douma, S., *Legal Status of the OECD Commentaries – In Search of the Holy Grail of International Tax Law*, in Bulletin for International Taxation, Vol. 61 (2007), No. 8, p. 342; Engelen, F. A., *Interpretation of Tax Treaties under International Law - A study of Articles 31, 32 and 33 of the Vienna Convention on the Law of Treaties and their application to tax treaties*, IBFD Doctoral Series Vol. 7, IBFD Publications, 2004, p. 57; Jeffery, R. J., *The Impact of State Sovereignty on Global Trade and International Taxation*, Series on International Taxation (No 23), Kluwer Law International, 1999, p. 108; Vogel, K. and Prokisch R. G., General Report, in *Interpretation of Double Taxation Conventions*, Cahiers de droit fiscal international, Volume LXXVIIIa, 1993 Florence Congress, Kluwer Law and Taxation Publishers, 1993, pp. 66 – 67 (English version); Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in British Tax Review, PART I, Vol. 1, 1984, p. 15. See, in particular, Vogel, K. et al., *Klaus Vogel On Double Taxation*

The articles of the Vienna Convention governing treaty interpretation are based on the use of common definitions. This is especially clear from art. 31(1) according to which ‘*A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.*’ The definition of treaty terms is based on their international ordinary meaning.

This general principle is, however, widely restricted by the functioning itself of the OECD Model Convention and the structure of its distributive rules which are based – as already explained – on a closed interrelation between treaty provisions and the national law of each contracting party.

The following passage of Avery Jones and his co-authors is explicative on this point. They quote the French author Tixier and explain: ‘*Tixier makes the point that “double taxation agreements have fundamentally different aims from classic political or economic treaties. They provide links between two tax systems from which they necessarily take their technical vocabulary.”*

*Tax treaties have a greater connection with internal law than most other types of treaty. In most States their effect is to relieve from tax in that State and not to charge tax. It makes sense therefore if the relieving provisions correspond with the taxing provisions of internal law [emphasis added]*<sup>24</sup>.

This is clearly the starting point of an analysis of art. 3(2) which is aimed at verifying whether this treaty provision can give rise to cases of tax treaty override. Art. 3(2), which is peculiar to tax treaties<sup>25</sup>, reverts the system on which art. 31 of the Vienna Convention is based. Priority is given to domestic definitions which apply unless a common intention exists according to the treaty context. Although the practicability of a system based on ‘classification and assignment of sources’ was excluded in the Report On Double Taxation requested by the

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*Conventions*, Kluwer Law International, Third Edition, 1997, p. 35: ‘... the rules of the Vienna Convention are used in case law on the Interpretation of Double Taxation Treaties today as a basis even with regard to States which have not yet ratified the Vienna Convention (e.g. High Court of Australia, *Thiel v. FCT*, 21 ATR 531, 541ff (1990)). The International Fiscal Association firmly supported this through a resolution at its 1993 Congress in Florence. According to the view of this Commentary, they constitute customary international law (supra m.no. 27)’.

<sup>24</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 17. For the original French version of the reported text of Tixier, see Tixier, G., Gest, G. and Kerogues, J., *Droit fiscal international - pratique française*, Librairies Techniques (LITEC), Twelfth Edition, 1979, p. 180: ‘Or, les conventions fiscales ont un objet fondamentalement différent de celui des traités politiques ou économiques traditionnels. Elles constituent des traits d’union entre deux législations fiscales nationales, dont elles empruntent nécessairement le vocabulaire technique.’

<sup>25</sup> See, for example, Avery Jones, J. F. et al., *The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States*, in *Bulletin For International Fiscal Documentation*, Vol. 60 (2006) No. 6, p. 229: ‘... Art. 3(2) seems to be used only in tax treaties ...’; Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 16: ‘Art. 3(2) appears to be a provision peculiar to tax treaties ...’

League of Nations<sup>26</sup>, this is exactly the system on which the current OECD Model Convention is founded. However, classification is not based – except for a few cases – on common treaty definitions but on domestic definitions.

In effect, art. 3(2) represents an alternative to the elaboration of a conspicuous and inevitably incomplete number of treaty definitions<sup>27</sup>.

The state applying the relevant treaty uses the definitions of the state of source. This system, originally proposed by Avery Jones and his co-authors<sup>28</sup>, in 2000 has been adopted by the OECD Commentary to articles 23A and 23B of the Model Convention following the OECD Partnership Report<sup>29</sup>.

Thus, the functioning of art. 3(2) of the OECD Model Convention is based on the domestic qualification of income and capital adopted by the state of source and exactly because the state that applies the treaty follows this qualification, the provision at issue guarantees<sup>30</sup> that the treaty relieving provision corresponds to the domestic tax provision.

<sup>26</sup> Bruins, G. W. J., Einaudi, L., Seligman, E. R. and Stamp, J. C., Report on double taxation submitted to the financial Committee of the League of Nations, League of Nations, 1923, p. 45.

<sup>27</sup> Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 124; Avery Jones, J. F., National Report – United Kingdom, in *Interpretation of Double Taxation Conventions*, Cahiers de droit fiscal international, Volume LXXVIIIa, 1993 Florence Congress, Kluwer Law and Taxation Publishers, 1993, p. 608.

<sup>28</sup> This was the position originally maintained by Avery Jones and his co-authors. See Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 48 *et seq.*

<sup>29</sup> This solution avoids conflicts of qualification since the state of residence recognizes a relief according to the law of the state of source (as long as there is no doubt about the correct application of the convention). See OECD Commentary on articles 23A and 23B paragraphs 32.1 *et seq.* For a debate about the limits of the OECD's approach and the residual cases of conflicts of qualification, see Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 126 – 132; Avery Jones, J. F., TAX TREATY MONITOR – *Conflicts of Qualification: Comment on Prof. Vogel's and Alexander Rust's Articles*, in *Bulletin For International Fiscal Documentation*, Vol. 57 (2003), No. 5, pp. 184 – 186; Rust, A., *The New Approach to Qualification Conflicts has its Limits*, in *Bulletin for International Fiscal Documentation*, Vol. 57 (2003), No. 2, pp. 45 – 50; Vogel, K., *Conflicts of Qualification: The Discussion is not Finished*, in *Bulletin for International Fiscal Documentation*, Vol. 57 (2003), No. 2, pp. 41 – 44. The authors agree that the remaining cases of conflict of qualification which are not solvable through the OECD's approach are very limited. With regard to art. 3(2) Vogel specifies that they are '*reduced to a small remaining set*' (p. 43).

<sup>30</sup> However, as emphasized in the previous footnote (No. 29), there are still limited problems of conflicts of qualification.

#### **4. Art. 3(2) of the OECD Model Convention and the possibility to cause a tax treaty override**

Art. 3(2) of the OECD Model Convention did not give rise to particular interpretative issues until the early Eighties when the soundness of an ambulatory interpretation started to be questioned<sup>31</sup>.

The Supreme Court of Canada in *The Queen v. Melford Developments Inc.* case<sup>32</sup> refused to use the meaning of a term as amended after the conclusion of the relevant treaty (so-called ambulatory interpretation) because it would allow a unilateral amendment to the applicable Convention.

After the Melford case the issue whether art. 3(2) allowed an ambulatory interpretation became crucial and it was deeply discussed among tax lawyers<sup>33</sup>. In particular, they started to debate whether a contracting state could only apply the internal meaning that a term had at the moment of the conclusion of a treaty or whether the new meaning it acquired in case of a domestic law amendment, subsequent to the conclusion of the treaty, could also be used.

It is only in 1992 that the OECD Commentary has been changed. It has been made clear that an ambulatory interpretation was already intended to apply<sup>34</sup>.

The wording of article 3(2) was changed in 1995 when it was explicitly stated that the domestic meaning of undefined treaty terms shall be that existing at the moment when the treaty is applied and not the meaning relevant at the moment when the treaty was concluded, unless the context otherwise requires.

Certainly, the ambulatory interpretation approach weakens the legitimate expectation principle.

In fact, an ambulatory interpretation determines a partial derogation from both art. 26 of the Vienna Convention – which establishes the *pacta sunt servanda* rule – and art. 27 of the same Convention – according to which domestic law cannot justify a breach of an international treaty. National definitions, which through the interpretative treaty clause of article 3(2) contributes to define the content of an international agreement, can be amended thus determining a posterior unilateral modification of the treaty. This result is obtained by an implicit attribution of retroactive effect to an amendment to domestic law.

The main purpose of this paragraph is to establish whether tax treaty override can occur in connection with article 3(2) of the OECD Model Convention. Specifically, the issue that needs to be solved is whether tax treaty override occurs

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<sup>31</sup> Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 64.

<sup>32</sup> Supreme Court of Canada, *The Queen v. Melford Developments Inc.*, 1982, D.T.C. 6281.

<sup>33</sup> See, in particular, Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, pp. 14–54; PART II, Vol. II, 1984, pp. 90 – 108.

<sup>34</sup> Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 132 – 133.

when limits to the amendment and application of domestic law – as established by the context – are exceeded.

It is worth noting that an ambulatory interpretation is not the only way to possibly exceed the limits established by the treaty context. These limits are exceeded every time a domestic definition is amended and applied for treaty purposes although the treaty context requires a different definition. It is clear, however, that the possibility of an ambulatory interpretation facilitates unilateral amendments and makes it even more difficult to establish the extent to which these unilateral amendments are in fact allowed.

Vogel noted: *‘One opportunity, but not the only one, to improve a State’s legal situation under a treaty comes from the ambulatory reference to domestic law: through a change of its domestic laws a contracting State is able to broaden the scope of circumstances which it is allowed to tax under a treaty. Whether such result is the purpose of a legislative change or whether it is an unintended side-effect of changes occasioned by other reasons cannot always be determined. This was exactly the ground why the Canadian courts supported a static interpretation of the reference to domestic law in the Melford case ...’*<sup>35</sup>.

Edwardes – Ker stated: *‘There is indeed one limitation to which the ambulatory approach must be subject. It can never have been intended that Art. 3(2) should be a licence to override a tax treaty. A state cannot justify a change in its domestic law which overrides a tax treaty on the grounds that a fully ambulatory approach permits the application of this changed law’*<sup>36</sup>

In addition, Rohatgi pointed out: *‘A State may redefine an undefined treaty term under its domestic law, which effectively overrides the treaty. Such changes in domestic law are permitted only when they are compatible with the context of the treaty and accepted by the other Contracting State...’*<sup>37</sup>

Finally, Shannon stated: *‘... [T]o the extent the reference to domestic law is ambulatory (applying to domestic law as amended), the treaty provides the contracting states an opportunity to modify their international obligations unilaterally by altering their domestic tax laws.’*<sup>38</sup>

The analysis conducted in the third chapter has highlighted that tax treaty override can occur either at the moment a new amending law is passed or at the moment the new domestic law is applied. In the first case a legislative treaty override is based on the coincidence of scope between national and international law. In the second case the new domestic legislation has a scope which is theoretically wider than the tax treaty scope. Only when domestic law is concretely applied for tax treaty purposes a judicial treaty override can occur.

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<sup>35</sup> Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 65.

<sup>36</sup> Edwardes – Ker, M., *Tax Treaty Interpretation*, Dublin: In-Depth 1994, Chapter 9, p. 7.

<sup>37</sup> Rohatgi, R., *Basic International Taxation*, Volume I: *Principles of International Taxation*, Richmond Law and Tax Ltd, Second Edition, 2005, p. 34.

<sup>38</sup> Shannon, H. A., *United States income tax treaties: Reference to domestic law for the meaning of undefined terms*, in *Intertax*, Vol. 17 (1989), No. 11, p. 455.

This is the case particularly relevant in connection with the interpretative clause of art. 3(2) of the OECD Model Convention.

When the debate about a static or ambulatory interpretation was still open, Avery Jones and his co-authors opted for the second solution but they clearly expressed the need to limit the possibility of domestic amendments. The authors identified two possible alternative solutions: an ‘express limitation’ which stems from the provision ‘*unless the context otherwise requires*’ and an ‘implied limitation’ which can be inferred from the OECD Commentary to art. 25(3). According to the statement which at that time was contained in paragraph 31 and is now contained in paragraph 52 of the Commentary to art. 25(3), ‘*where the laws of a State have been changed without impairing the balance or affecting the substance of the Convention, [the competent authorities can] settle any difficulties that may emerge from the new system of taxation arising out of such changes*’.

An ambulatory interpretation can, therefore, be adopted, according to Avery Jones and his co-authors, ‘*without impairing the balance or affecting the substance of the Convention*’<sup>39</sup>.

In a more recent work, Avery Jones has expressly excluded that art. 3(2) can affect cases of treaty override: ‘*It should be noted that this issue is unrelated to treaty override. Here the treaty contemplates changes in internal law and so such changes are not an override but are in accordance with the treaty. If the limit of permissible changes is exceeded the context requires that the change does not apply to the treaty. With override the change in internal law breaches the treaty, which is the opposite.*’<sup>40</sup>

Similarly, in its 1989 Report on treaty override the OECD has denied that art. 3(2) can give rise to cases of treaty override. It was pointed out: ‘*A State may change the definition of a term used in its domestic legislation which is also used in treaty provisions **but which is not specifically defined for the purposes of the treaty [emphasis added]**. In this case there is no override where the treaty contains a provision essentially similar to that embodied in Article 3, paragraph 2 ... It cannot have been contemplated that, having once entered into a treaty, a State would be unable to change definitions of terms used in its domestic law **provided such changes were compatible with the context of the treaty [emphasis added]***’.<sup>41</sup>

Indeed, each sovereign state can change those domestic definitions which, in principle, are meant to apply for domestic purposes only. However, when domestic definitions and treaty provisions have the same scope, state sovereignty is limited in the application of its domestic law for treaty purposes.

Clearly, a case of legislative treaty override is always possible when the law expresses the legislature’s will of overriding existing tax treaties. However, when

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<sup>39</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 48.

<sup>40</sup> Avery Jones, J. F., *The Interaction Between Treaty Provisions and Domestic Law*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 133.

<sup>41</sup> OECD, *Tax Treaty Override*, OECD 1989, p. 6.



investigating about possible cases of treaty override in connection with art. 3(2), the fact that it is an interpretative clause needs to be taken into consideration.

Article 3(2) *determines* the *application* of domestic definitions to complete the content of an international treaty.

The article at issue is one of the most significant provisions which aim at realizing the OECD functioning. It is an interpretative clause that establishes the application of domestic law to define treaty terms. Domestic definitions become an integral part of the tax treaty which is being interpreted. Art. 3(2) modifies the scope of domestic definitions and actually extends their scope for treaty purposes. Moreover, art. 3(2) allows an ambulatory interpretation and, therefore, a legitimate unilateral modification of the treaty which is being applied. This unilateral modification is illegitimate when domestic law which exceeds the treaty context is *applied*. Art. 3(2) of the OECD Model Convention postpones the possible occurrence of a tax treaty override until the moment of *application* of the national definition. This exactly depends on the structure of art. 3(2) which is an interpretative clause based on the application of domestic law for tax treaty purposes. The violation of the limits established by art. 3(2), i.e. the treaty context limits, determines the application of a domestic definition that unilaterally amends the treaty and specifically the treaty provision containing the undefined term.

To synthesize, in connection with art. 3(2) of the OECD Model Convention a case of legislative treaty override can only occur when the scope of an amended domestic definition is extended to cover treaty purposes. This usually happens through the express will to override existing tax treaties. The conflict is irrelevant when national legislation does not apply for treaty purposes because in this case no unilateral amendment of the previous treaty is possible.

When an amended domestic definition has a domestic scope and it is applied for treaty purposes only by virtue of art. 3(2) of the OECD Model Convention, a tax treaty override can be caused only judicially through the application of a domestic definition which exceeds the treaty context.

*A fortiori* a case of judicial tax treaty override will occur when a domestic amended definition applies while the context excludes the possibility of an ambulatory interpretation, i.e. when the context makes it clear that the treaty term must be applied with the meaning it had at the moment the treaty was concluded.

What is also important to highlight is that in all the cases of tax treaty override based on the application of art. 3(2), this last treaty provision is not overridden, i.e. it is not unilaterally amended. However, it is breached and it is exactly the violation of the interpretative rule contained in art. 3(2) that overrides (causes the unilateral amendment of) the provision using the relevant undefined term.

This means that if, for example, art. 3(2) is applied to interpret the notion of capital gains and the limits of the treaty context are not respected (the domestic definition is applied instead of the contextual one), this incorrect application of art. 3(2) determines the use of an inexact definition of capital gains. Consequently, art. 3(2) is breached and art. 13 is overridden.



Therefore, although art. 3(2) does not allow to amend and apply for treaty purposes definitions that exceed the limits of the treaty context, when art. 3(2) is violated because a domestic term is amended and applied exceeding the treaty context limits, a tax treaty override occurs with respect to the treaty provision which contains the undefined term at issue.

When Avery Jones excludes that art. 3(2) can give rise to cases of tax treaty override, he does not take into consideration the possibility that the breach of the provision at issue can cause a unilateral amendment of the treaty provision mentioning the undefined term. The British author limits his analysis to cases of legislative treaty override stemming from a formal conflict of laws. Therefore, Avery Jones denies that tax treaty override can occur on the basis of art. 3(2) which excludes the application of a domestic definition exceeding the treaty context.

Avery Jones founds his position on a lawful application of art. 3(2) and does not consider that a breach of the provision at issue – either through the amendment of a domestic definition that has directly effects on a tax treaty (legislative treaty override) or through the application of an amended definition for treaty purposes (judicial treaty override) – can override the treaty provision using the undefined term when the limits deriving from the treaty context are exceeded. Furthermore, art. 3(2) is an interpretative provision. Interpretation is not an objective process. Establishing the limits that derive from the treaty context is difficult and surely it is not an operation that leads to mathematical results. These limits can be exceeded voluntarily or involuntarily. When they are exceeded, art. 3(2) is breached and the treaty provision which uses the undefined term at issue is overridden.

In fact, the 1989 OECD Report on treaty override has excluded that treaty override can occur in connection with art. 3(2) to the extent that domestic definitions *[are] not specifically defined for the purposes of the treaty*. In this case, indeed, domestic sovereignty cannot be considered limited by an international treaty.

Again, this position does not take into consideration the characteristic interpretative function of art. 3(2). It *determines* the application for treaty purposes of domestic definitions which are not *'specifically'* adopted for treaty purposes. When these definitions are applied for treaty purposes by virtue of art. 3(2) a treaty override occurs if they exceed the limits deriving from the treaty context.

## **5. The treaty context as a limit to tax treaty override**

It is clear from the previous paragraph that cases of tax treaty override can be realized in connection with art. 3(2) of the OECD Model Convention. Both cases of legislative and judicial treaty override are possible. Cases of legislative treaty override are based on a conflict between a newly adopted domestic definition and the relevant tax treaty. Cases of judicial treaty override are based

on the application – for treaty purposes – of a domestic definition which is – in principle – meant to apply for domestic purposes only. However, art. 3(2) determines its application for treaty purposes as well. Both legislative and judicial treaty override are based on a breach of art. 3(2). The amendment and application for treaty purposes of domestic definitions are admissible to the extent that the treaty context does not require otherwise. When the limits established within the context are exceeded, art. 3(2) is breached and the treaty provision which uses the undefined term at issue is overridden.

The following paragraphs will clarify the scope and meaning of the provision ‘*unless the context otherwise requires*’ in order to understand when the limits deriving from the treaty context are actually exceeded and a tax treaty override is realized.

### 5.1 ‘*Internal*’ and ‘*external*’ context

An exact understanding of the provision ‘*unless the context otherwise requires*’, which is mentioned in art. 3(2) of the OECD Model Convention, certainly presupposes an examination concerning the notion of context.

Paragraph 12 of the OECD Commentary to art. 3 contains a really general definition: ‘*The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based ...)*’.

A concrete understanding of paragraph 12 of the Commentary to art. 3 presupposes an analysis of the definition of context as delineated within the Vienna Convention on the Law of Treaties. However, as already clarified above, this study follows the position according to which art. 3(2) is *lex specialis* in relation to the general interpretative rules of the Vienna Convention. This involves the necessity to examine to what extent the notion of context, as defined within the Vienna Convention, is applicable to art. 3(2).

According to art. 31(1) of the Vienna Convention ‘*A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.*’

The definition of context is given in art. 31(2) of the Vienna Convention: ‘*The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:*

- (a) *any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;*
- (b) *any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.*’

This definition of context is generally recognized as being rather limited<sup>42</sup>. Therefore, this is called ‘textual’ or ‘internal’ context as opposed to a wider ‘legal’ or ‘external’ context.<sup>43</sup>

According to Art. 31(3) of the Vienna Convention ‘*There shall be taken into account together with the context:*

*any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;*

*any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;*

*any relevant rules of international law applicable in the relations between the parties’.*

As highlighted by Avery Jones and his co-authors, subsequent agreements and practice do not have a ‘subsidiary role’<sup>44</sup> with regard to the context as *strictu sensu* conceived in art. 31(2) of the Vienna Convention. Indeed, it is clear from the wording of art. 31(3) and specifically from the sentence ‘*[t]here shall be taken into account*’ that subsequent agreements and practice are not part of the context *strictu sensu*. However, in the Sixth Report on the Law of Treaties was stated: ‘*these words [‘There shall be taken into account’] were intended by the Commission to put such interpretative agreements on the same level as the “context” and to indicate that an interpretative agreement is to be taken into account as if it were part of the treaty.*’<sup>45</sup>

Thus, Avery Jones and his co-authors considered subsequent agreements and practice substantially part of the context<sup>46</sup> and specifically as part of the so-called *external* context.

In addition, art. 32 of the Vienna Convention establishes the possibility to use supplementary means of interpretation, although this possibility is expressly rather limited. Supplementary means of interpretation can be used only to confirm the interpretation resulting from the application of art. 31 or to

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<sup>42</sup> Ward, D. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IBFD Publications BV, 2005, pp. 30 –31; Vogel, K., *The Influence of the OECD Commentaries on Treaty Interpretation*, in Bulletin for International Fiscal Documentation, Vol. 54 (2000), No. 12, p. 614; Avery Jones, J. F et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in British Tax Review, PART II, Vol. II, 1984, p. 90; Tixier, G., Gest, G. and Kerogues, J., *Droit fiscal international - pratique française*, Librairies Techniques (LITEC), Twelfth Edition, 1979, p. 172.

<sup>43</sup> Ward, D. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IBFD Publications BV, 2005, pp. 30 –31; Avery Jones, J. F et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in British Tax Review, PART II, Vol. II, 1984, p. 92.

<sup>44</sup> Avery Jones, J. F et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in British Tax Review, PART II, Vol. II, 1984, p. 95.

<sup>45</sup> Document A/CN.4/186 and Add.1-7. Sixth Report on the Law of Treaties, by Sir Humphrey Waldock, Special Rapporteur, in Yearbook of the International Law Commission, 1966, Vol. II, p. 95.

<sup>46</sup> Avery Jones, J. F et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in British Tax Review, PART II, Vol. II, 1984, p. 90 – 91.

clarify the interpretation according to art. 31 when it leads to an uncertain or unreasonable result. Indeed, the means of interpretation referred to in art. 32 are supplementary since they cannot contradict the interpretation deriving from art. 31 but only confirm or clarify it<sup>47</sup>.

Furthermore, art. 32 leaves open the category of the means of interpretation that can be used. Only ‘*the preparatory work of the treaty and the circumstances of its conclusion*’ are mentioned<sup>48</sup>.

According to Villinger, preparatory work of the treaty “... includes all documents relevant to a forthcoming treaty and generated by the parties during the treaty’s preparation up to its conclusion ... These travaux préparatoires include memoranda and other statements and observations of governments transmitted to each other or to the drafting body; diplomatic exchanges between the parties; treaty drafts; negotiation records; and minutes of commission and plenary proceedings”.<sup>49</sup>

Engelen also gives some examples of preparatory work: ‘*the records of the negotiations preceding the treaty’s conclusion, the minutes of the plenary meetings and of the committees of the conference that adopted the treaty, the successive drafts of the treaty, etc.*’.<sup>50</sup>

Preparatory work can be extremely important in revealing the contracting parties’ intention at the moment of the conclusion of a treaty. Nevertheless, one should avoid the use of works which are expression of the intention of one party only<sup>51</sup>.

In conclusion, according to Avery Jones and his co-authors, when determining the concept of context applicable to art. 3(2) of the OECD Model Convention, one should take into consideration the entire system of interpretation established

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<sup>47</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART II, Vol. II, 1984, p. 97.

<sup>48</sup> According to art. 32 of the Vienna Convention: ‘*Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:*

(a) leaves the meaning ambiguous or obscure; or

(b) leads to a result which is manifestly absurd or unreasonable.’

<sup>49</sup> Villinger, M. E., *Commentary on the 1969 Vienna Convention on the Law of Treaties*, Martinus Nijhoff Publishers, 2009, p. 445.

<sup>50</sup> Engelen, F. A., *Interpretation of Tax Treaties under International Law - A study of Articles 31, 32 and 33 of the Vienna Convention on the Law of Treaties and their application to tax treaties*, IBFD Doctoral Series Vol. 7, IBFD Publications, 2004, p. 335.

<sup>51</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART II, Vol. II, 1984, pp. 97- 98.

within the Vienna Convention through art. 31, art. 32 and, when relevant, art. 33<sup>52 53</sup>.

Avery Jones and his co-authors highlighted that an application of the limited definition contained in art. 31(2) of the Vienna Convention would be a non-sense when interpreting art. 3(2). This limited definition of context would always determine the application of the national meaning of a term which is only mentioned and not defined within the text of a treaty<sup>54</sup>.

*‘Applying the Vienna context definition to the expression “unless the context otherwise requires” would make no sense because the Vienna context was not meant to be used in isolation from these other factors. It is therefore suggested that all of the items which may be taken into account, or to which one may have recourse, in interpreting treaties generally, should be considered as “context” in the expression “unless the context otherwise requires” ... Context therefore should mean anything that can normally be taken into account or to which one may have recourse in interpreting the treaty.’*<sup>55</sup>

As already said, the expression ‘unless the context otherwise requires’ has Anglo-Saxon origins and for this reason Avery Jones and his co-authors suggest – specifying that they have no certain position on this point – an alternative solution when interpreting the notion of context within the clause ‘unless the context otherwise requires’. ‘Context’ could also be understood according to the British case law.

Avery Jones and his co-authors quote the following two passages of two different judgments as emblematic of the extent of the ‘context’ in the British case law.

In *A-G v. Prince Ernest Augustus of Hanover* case it was stated: *‘Words and particularly general words, cannot be read in isolation, their colour and content is derived from their context. So it is that I conceive it to be my right and duty to examine every word of a statute in its context, and I use “context” in its widest sense, which I have already indicated as including not only other enacting provisions of the same statute but its preamble, the*

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<sup>52</sup> Art. 33 of the Vienna Convention refers to conventions which are been concluded in more than one official language. The article establishes exactly:

*‘1. When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.*

*2. A version of the treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.*

*3. The terms of the treaty are presumed to have the same meaning in each authentic text.*

*4. Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted’.*

<sup>53</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in British Tax Review, PART II, Vol. II, 1984, p. 104.

<sup>54</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in British Tax Review, PART II, Vol. II, 1984, p. 104.

<sup>55</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in British Tax Review, PART II, Vol. II, 1984, p. 104.

existing state of the law, other statutes in *pari materia*, and the mischief which I can, by those and other legitimate means, discern the stature was intended to remedy.’<sup>56</sup>

In *Ealing Borough Council v. Race Relations Board* case it was stated ‘The Courts have five principal avenues of approach to the ascertainment of legislative intention: (1) examination of the social background, as specifically proved if not within common knowledge, in order to identify the social or juristic defect which is likely subject of remedy; (2) a conspectus of the entire relevant body of the law for the same purpose; (3) particular regard to the long title of the statute to be interpreted (and, where available, the preamble), in which the general legislative objectives will be stated; (4) scrutiny of the actual words to be interpreted in the light of the established canons of interpretation; (5) examination of the other provisions of the statute in question (or of other statutes in *pari materia*) for the light which they throw on the particular words which are the subject of interpretation.’<sup>57</sup>

The notion of context according to British case law, thus, include both the ‘internal’ and the ‘external’ context and it is actually wider than the concept resulting from the Vienna Convention. British case law also includes ‘(1) examination of the social background, as specifically proved if not within common knowledge, in order to identify the social or juristic defect which is likely subject of remedy’ and ‘(2) a conspectus of the entire relevant body of the law for the same purpose’.

However, as emphasized by Avery Jones and his co-authors, the adoption of one or the other conception of context has limited consequences, since the only practical difference is that according to the British case law supplementary means of interpretation can also be used when the interpretative result is not ambiguous or absurd<sup>58</sup>.

Essential to our purposes is to establish whether this wide notion of context also covers the OECD Commentaries

The problem concerning the status of the OECD Commentaries and their categorization according to articles 31 or 32 of the Vienna Convention has extensively been analyzed in literature<sup>59</sup>.

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<sup>56</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART II, Vol. II, 1984, p. 91.

<sup>57</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART II, Vol. II, 1984, p. 91.

<sup>58</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART II, Vol. II, 1984, pp. 104 – 105.

<sup>59</sup> *Ex multis*, Douma, S. and Engelen, F. (editors), *The legal Status of the OECD Commentaries*, Conflict of Norms in International Tax Law Series, Volume I, IBFD, 2008; Lang, M. and Brugger, F., *The role of the OECD Commentary in tax treaty interpretation*, in *Australian Tax Forum*, Vol. 23 (2008), pp. 95 – 108; Erasmus – Koen, M. and Douma, S., *Legal Status of the OECD Commentaries – In Search of the Holy Grail of International Tax Law*, in *Bulletin for International Taxation*, Vol. 61 (2007), No. 8, pp. 339 – 352; Ward, D. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IBFD Publications BV, 2005; Wattel, P. J. and Marres, O., *The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties*, in *European Taxation*, Vol. 43 (2003), No. 7 – 8, pp. 222 – 235; Ellis, M. J., *The Influence of the OECD Commentaries on Treaty Interpretation – Response to Prof. Dr. Klaus Vogel*, in

The main problem concerns the non binding nature of the Commentaries which are, moreover, adopted in connection to a model convention and not to a specific concluded tax treaty<sup>60</sup>.

It is outside the scope of this work to analyze the many different stances that have been taken on this subject-matter.

From my point of view a wide notion of context which also includes the OECD Commentaries as an instrument that can be expression of the common intentions of the parties is applicable. However, since the wording and the drift of the OECD Commentaries can be very different, the fact that they effectively represent the common intentions of the parties needs to be proved case by case. Furthermore, only the OECD Commentaries existing at the moment when a specific treaty is concluded can be considered part of the treaty context<sup>61</sup>.

According to Ward and his co-authors, it is possible that the OECD Commentaries express the special meaning of an undefined treaty term under art. 31(4)<sup>62</sup> of the Vienna Convention. In this case it needs to be proved that '*the parties to the bilateral treaty so intended*.'<sup>63</sup>

The authors also specify that often the OECD Commentaries have an extensive content which goes certainly beyond the definition of treaty terms. Although in this case articles 31 and 32 of the Vienna Convention might not be applicable because of their more limited scope, Ward and his co-authors do not doubt about the possibility to include the Commentaries within the notion of context

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Bulletin for International Fiscal Documentation, Vol. 54 (2000), No. 12, pp. 617 – 618; Vogel, K., *The Influence of the OECD Commentaries on Treaty Interpretation*, in Bulletin for International Fiscal Documentation, Vol. 54 (2000), No. 12, pp. 612 – 616; Ault, H. J., *The Role of the OECD Commentaries in the Interpretation of Tax Treaties*, in Alpert, H. H. and Van Raad, K. (editors), *Essays on International Taxation* – in honor of Sidney I. Roberts, Series on International Taxation, Kluwer law and Taxation Publishers, 1993, pp. 61 – 68;

<sup>60</sup> Ward, D. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IBFD Publications BV, 2005, p. 18.

<sup>61</sup> Ex multis, Ward, D. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IBFD Publications BV, 2005, p. 30; Wattel, P. J. and Marres, O., *Characterization of Fictitious Income under OECD-Patterned Tax Treaties*, in European Taxation, Vol. 43 (2003), No. 3, p. 71.

<sup>62</sup> Article 31(4) of the Vienna Convention states: '*A special meaning shall be given to a term if it is established that the parties so intended.*'

<sup>63</sup> Ward, D. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IBFD Publications BV, 2005, p. 30.



by virtue of the principles of logic and good sense<sup>64</sup> which underlie the Vienna Convention<sup>65</sup>.

From the collocation of the OECD Commentaries within the scope of art. 31(4) of the Vienna Convention, Ault derives the conclusion according to which there is a presumption that any definition contained in the OECD Commentaries represents the intention of the contracting parties, unless they expressed observations or reservations<sup>66</sup>.

Vogel is of the opinion that a different characterization needs to be conducted on the basis of the longevity of the Commentaries at issue.

Term definitions already contained in the 1963 OECD Commentaries and that have never been changed can be considered to have an ‘ordinary meaning’. This is mostly true also for those term definitions introduced in the 1977 OECD Commentaries. Only if a tax treaty was concluded during the first year the Commentaries were adopted it could be doubted that a term has – in respect to that specific treaty – an ordinary meaning. However, according to Vogel, this evaluation needs to be conducted case by case. The definitions introduced in the Commentaries following the 1977 version can be presumed to have a ‘special meaning’ under art. 31(4) of the Vienna Convention but only when a certain period of time has elapsed from the amendment of the Commentaries to the conclusion of the relevant tax treaty. If not enough time has elapsed in order to presume a special meaning the Commentaries can be considered supplementary means of interpretation under art. 32 of the Vienna Convention<sup>67</sup>.

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<sup>64</sup> The Commentaries to the Vienna Convention make it clear that the relevant interpretative system is not exhaustive and consequently it allows the use of unwritten principles, mostly principles of logic and good sense : ‘... it would be possible to find sufficient evidence of recourse to principles and maxims in international practice to justify their inclusion in a codification of the law of treaties, if the question were simply one of their relevance on the international plane. But the question raised by jurists is rather as to the non-obligatory character of many of these principles and maxims. They are, for the most part, principles of logic and good sense valuable only as guides to assist in appreciating the meaning which the parties may have intended to attach to the expressions that they employed in a document. Their suitability for use in any given case hinges on a variety of considerations which have first to be appreciated by the interpreter of the document ...’. See Ward, D. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IBFD Publications BV, 2005, pp. 27 – 28.

<sup>65</sup> Ward, D. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IBFD Publications BV, 2005, p. 30. See also footnote No. 69. About the principles of logic and good sense underlying the Vienna Convention on the Law of Treaties see below in this chapter.

<sup>66</sup> Ault, H. J., *The Role of the OECD Commentaries in the Interpretation of Tax Treaties*, in Alpert, H. H. and Van Raad, K. (editors), *Essays on International Taxation* – in honor of Sidney I. Roberts, Series on International Taxation, Kluwer law and Taxation Publishers, 1993, pp. 64 – 66.

<sup>67</sup> Vogel, K., *The Influence of the OECD Commentaries on Treaty Interpretation*, in Bulletin for International Fiscal Documentation, Vol. 54 (2000), No. 12, p. 616.



The role of the OECD Commentaries in interpreting tax treaties has been firmly stated by the American Law Institute: ‘... [T]he OECD Model Treaty and the accompanying Commentary are the benchmarks against which income tax treaties between developed countries are negotiated. Many treaties, including most U.S. treaties, incorporate language of the OECD Model Treaty or, in some cases, deliberately modify it for specified reasons. While the OECD materials undoubtedly do not rise to the level of customary international law, they occupy a unique position in the hierarchy of international tax materials. In practice both administrators and tax advisors automatically consult these materials when attempting to understand the meaning of treaty provisions. It would be wholly unrealistic, at least in the absence of a strong evidence to the contrary, to think that treaty negotiators who adopted language derived from the OECD text were not familiar with and therefore did not knowingly accept the common meaning of that language as agreed among the OECD member countries.’<sup>68</sup>

### 5.2 ‘Unless the context otherwise requires’

Defining the scope and the exact meaning of the provision ‘*unless the context otherwise requires*’ is indispensable in order to establish whether a case of tax treaty override has occurred in connection with art. 3(2) of the OECD Model Convention. A domestic definition can be amended and applied for treaty purposes to the extent that the limits established within the treaty context are not exceeded.

What does exactly mean that the context requires otherwise ? And when does the context require otherwise ?

The use of domestic definitions for treaty purposes – exactly because it is a derogation from the use of a common meaning – can cause double taxation or double non-taxation. This is true even if the definition of the state of source is followed.

This argument has lead some authors to recognize a central role to the context and to maintain that only when there is no possibility of constructing a definition through the context domestic law is applicable<sup>69</sup>. Some authors have argued this position also by emphasizing the statement contained in paragraph 21(c) of the OECD Commentary to art. 11(3): ‘*in the Model Convention references to domestic laws should as far as possible be avoided.*’<sup>70</sup>

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<sup>68</sup> American Law Institute, *Federal income tax project: international aspects of United States income taxation II: proposals on United States income tax treaties*, Philadelphia, PA : The American Law Institute, 1992, p. 54.

<sup>69</sup> See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 213; Vogel, K. and Prokisch R. G., General Report, in *Interpretation of Double Taxation Conventions*, Cahiers de droit fiscal international, Volume LXXVIIIa, 1993 Florence Congress, Kluwer Law and Taxation Publishers, 1993, p. 81 (English version)

<sup>70</sup> Aramini, F and Savini, N., *La nozione di beneficial owner nel diritto internazionale tributario e nel diritto tributario comunitario*, in *Diritto e pratica tributaria internazionale*, No. 3/2002,

Indeed, the preference of the OECD is for the highest possible level of legal certainty. However, the wording of art. 3(2) does not allow the ordinary process of treaty interpretation which is primary aimed at finding a common treaty meaning<sup>71</sup>. As emphasized many times, art. 3(2) has established an exception which introduces national definitions for treaty purposes.

The article at issue states that any term not defined within a tax treaty shall have the meaning that it has under domestic law unless the context otherwise requires.

As prominent authors<sup>72</sup> have emphasized, ‘requires’ is a word that denotes a certain strength. This means that a contextual definition can apply only when there is strong evidence that the contracting parties have attached a common meaning to a certain term.

Vogel adds that treaty context and domestic law should be mutually examined: ‘... **whether** the context ‘otherwise requires’, viz. an approach other than recourse to domestic law, can, **in accordance with the rules of logic**, be determined only if the meaning of a term has **previously** been established under that law. From this, it would seem that an interpretation according to domestic law should take preference ... Since,

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p. 995.

<sup>71</sup> See also Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART II, Vol. II, 1984, pp. 107–108.

<sup>72</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 277; Ward, D. et al., *The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries on the OECD Model*, IBFD Publications BV, 2005, p. 31; Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 214: ‘It is ... expressly stated that not every apparently convincing interpretation from the context should give rise to a divergence from the rule of Art. 3(2), but only those **based on relatively strong arguments**.’; Vogel, K. and Prokisch R. G., General Report, in *Interpretation of Double Taxation Conventions*, Cahiers de droit fiscal international, Volume LXXVIIIa, 1993 Florence Congress, Kluwer Law and Taxation Publishers, 1993, p. 81 (English version); Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 18: ‘The Commentaries to the OECD Model must be strong evidence that the parties to a treaty, particularly if both are OECD members, intended the meaning set out in the Commentaries to apply.’; Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART II, Vol. II, 1984, p. 108: ‘What has to be done, as Vogel states, to apply the treaty’s internal rule of interpretation – Article 3(2) – in accordance with its terms: use internal law unless the context otherwise requires. Whether the context is strong enough to prevail is a matter which can be decided only on its facts in relation to each individual case, without attempting any form of approach according to a hierarchy. Requires is a word of some force, as is *exige* in the French version, and *erfordert* in the German unofficial translation published by the Ministry of Finance. The context must therefore be reasonably strong for the internal law meaning to be ousted.’

*however, such an interpretation may also require further correction both interpretation procedures must be viewed in mutual reciprocity [Vogel's emphasis] ...*<sup>73</sup>

This means that the context could also only limit the amendment and application of a domestic definition for treaty purposes. Often the OECD Commentaries do not contain exhaustive definitions. They only give some details or elements for interpretation that, as expression of the common intention of the parties, could actually limit the amendment and application for treaty purposes of domestic definitions. In short, a treaty definition can often result from the integration of treaty context and domestic law.

As already noted above, according to Avery Jones and his co-authors there are two possible limits to the ambulatory interpretation under art. 3(2). One is express while the other is implied. In the authors' view, the two solutions are alternative to each other, although they permit to achieve the same result<sup>74</sup>.

The express limitation is – indeed – asserted through the provision '*unless the context otherwise requires*'.

The implied limitation allows changes '*without impairing the balance or affecting the substance of the Convention*'<sup>75</sup>. Specifically, Avery Jones and his co-authors made reference<sup>76</sup> to the OECD Commentary to art. 25(3) – the then paragraph 31, now paragraph 52 – where it is stated that the competent authorities can '*where the laws of a State have been changed without impairing the balance or affecting the substance of the Convention, settle any difficulties that may emerge from the new system of taxation arising out of such changes*'.

In Avery Jones' view this statement reflects the limits deriving from art. 27 of the Vienna Convention, according to which a breach of international law cannot be justified by virtue of domestic legislation<sup>77</sup>.

Sinclair<sup>78</sup> considers the limits to an ambulatory interpretation inherent in art. 3(2) itself since it is part of the treaty text. For this reason this article, even without the express provision '*unless the context otherwise requires*', should be interpreted in

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<sup>73</sup> Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 214.

<sup>74</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 48.

<sup>75</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 48.

<sup>76</sup> Avery Jones, J. F. et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model*, in *British Tax Review*, PART I, Vol. 1, 1984, p. 48.

<sup>77</sup> Avery Jones, J. F., *Article 3(2) of the OECD Model Convention and the Commentary to it: Treaty Interpretation*, in *European Taxation* Vol. 33 (1993), No. 8, p. 254.

<sup>78</sup> Avery Jones, J. F., *Interpretation of Tax Treaties*, in *Bulletin for International Fiscal Documentation*, Vol. 40 (1986), No. 1, p. 85. [Note of the author: This article is the transcription by Mr Avery Jones of seminar B at the IFA Congress held in London in 1985.]; see also Avery Jones, J. F., National Report – United Kingdom, in *Interpretation of Double Taxation Conventions*, Cahiers de droit fiscal international, Volume LXXVIIIa, 1993 Florence Congress, Kluwer Law and Taxation Publishers, 1993, pp. 609-610.

a way that excludes a result contrary to the object and purpose of the treaty or that disrupts its balance.

According to Sinclair, the same limits derive from art. 27 of the Vienna Convention exactly because contracting states cannot invoke the provisions of their domestic law to justify a breach of a treaty.

The mentioned authors found an implied limit to the ambulatory interpretation in the necessity to preserve the balance (which also involves the purpose and object of the treaty) established by the parties at the moment the treaty was concluded. Thus, domestic law cannot be amended and applied for treaty purposes to the extent that the original treaty balance is disrupted.

An analysis of the literature concerning the scope of ambulatory interpretation shows that in the authors' view there is a substantial coincidence between – using Avery Jones' words – the express and the implied limitations. Thus, the context requires otherwise when the limits inherent in the relevant distributive rule, as originally conceived by the parties, are exceeded so that the original balance is disrupted.

This is clearly expressed by De Broe: *'What then is necessary in case of subsequent amendments of domestic law to set aside the domestic law meaning? It is submitted that the answer is the same as under the implied limitation to ambulatory interpretation [articles 26 and 27 of the Vienna Convention] ... The context requires that amendments to domestic law meanings are disregarded where the effect of such changes is that the State amending its domestic laws extends its taxing rights beyond what could have reasonably been foreseen by its treaty partner when the treaty was concluded and impairs the balance of the treaty and/or defeats the treaty's object and purpose. **Such will in particular occur where the change to domestic law permits a State to recapture taxing rights which it had forgiven to its treaty partner upon concluding the treaty[emphasis added].'***

<sup>79</sup>

This position is supported by the OECD Commentary to art. 3(2). Paragraph 12 defines the concept of context and states: *'... [t]he context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway'.*

*'Consequently' – continues the following paragraph 13 – 'the wording of paragraph 2 [of art. 3] provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided)'.*

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<sup>79</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, pp. 277-278.

Wattel and Marres<sup>80</sup> highlighted the role of the principle of reciprocity. They maintained that, when paragraph 12 of the OECD Commentary mentions the intention of the parties at the moment of the conclusion of the treaty, the status of legislation of both contracting states at that moment is included within the notion of context<sup>81</sup>. For this reason, the further specific reference to the legislation of the other contracting state – according to the principle of reciprocity – is to be understood as a reference to the legislation as existing at the moment when the treaty is applied. Otherwise, the specific distinction made within the Commentary between the intention of the parties and the principle of reciprocity would be deprived of any real meaning.

As a consequence of this interpretation and in the light of the requirement contained in par. 13 of the Commentary to art. 3 which concerns the need to ensure the permanency of commitment, Wattel and Marres are of the opinion that the limits established by the context are exceeded when a contracting state modifies a domestic term so that the new definition could not be reasonably foreseen by the other contracting party. For this reason they exclude that these limits are exceeded when the other contracting state had already introduced an equivalent amendment.

The two authors distinguish three specific situations when they consider that the treaty context is exceeded: (i) when the interpretation of an amended definition has the result of including within the scope of one of the treaty distributive rules income which falls outside the scope of the treaty<sup>82</sup>; or (ii) when re-

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<sup>80</sup> Wattel, P.J. and Marres, O., *Characterization of Fictitious Income under OECD-Patterned Tax Treaties*, in *European Taxation*, Vol. 43 (2003), No. 3, pp. 71 – 72.

<sup>81</sup> The two authors significantly added: ‘*Indeed the parties have taken that legislation into account when negotiating and signing the treaty. For the same reason we submit that the OECD Model and the Commentary themselves are also “context” if that Model served as the point of departure for treaty negotiation, in particular of the resulting treaty follows the OECD Model verbatim[emphasis added]. See Wattel, P. J. and Marres, O., Characterization of Fictitious Income under OECD-Patterned Tax Treaties, in European Taxation, Vol. 43 (2003), No. 3, pp. 71 – 72;*

<sup>82</sup> It is interesting to note that the same reference, although broadly, is made by Prof. Vogel when explaining the treaty interpretation process involving art. 3(2) of the OECD Model Convention. Prof. Vogel explains that when neither a special meaning is attached to a treaty term nor special rules of interpretation apply, ‘the question to be asked is whether the **law of the State applying the treaty** (*lex fori*) attaches a special meaning to the term to the extent that it relates to **the taxes covered by the treaty**’. This consideration is made by Prof. Vogel when he explains that the interpretation of art. 3(2), in general, and the possibility that the context requires otherwise, more specifically, need to be considered according to the model of distributive rules elaborated by the scholar. ‘*Any reasons for adopting an interpretation deviating from domestic law have **additional weight** on the level of the distributive rule’s ‘Metatbestand’, in particular where the question involves determination of the **type of income, profit or capital** to which the distributive rule applies, or involves the **relevant tax base**. This additional weight derives from the fact that in cases of interpretation by recourse to the domestic law, the latter is particularly apt to lead to inappropriate results*’. See Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law

characterization of income determines the application of a distributive rule which is different than the distributive rule that the parties agreed upon and is more favourable for the amending state; or (iii) when the new definition is interpreted so that a relief for double taxation has no longer to be granted.

At the end of this chapter, after the examination of the case law concerning both notional income and exit tax, it will be clear that there is an aspect of this position I do not consider founded. I do not believe that a tax treaty override can be justified by virtue of a previous treaty override realized by the other contracting state. Both treaty overrides are illegitimate because they violate the principles of reciprocity and legitimate expectations. Paragraph 12 of the OECD Commentary to art. 3 includes within the notion of treaty context the intention of the parties at the moment of the conclusion of the treaty ‘as well as the meaning given to the term in question in the legislation of the other Contracting State’. Art. 3(2) of the OECD Model Convention allows an ambulatory interpretation, and therefore guarantees the possibility to amend domestic definitions. However, this is possible only within certain limits. When these limits are exceeded both contracting states realize a tax treaty override.

## **6. A practical application of art. 3(2) of the OECD Model Convention: when a domestic deeming provision causes a treaty override**

The limits to an ambulatory interpretation under art. 3(2) of the OECD Model Convention have been analyzed by the Dutch Supreme Court in cases concerning the attribution of notional income<sup>83</sup>.

To my knowledge, this is the only case law – in addition to the case law concerning exit taxation which will be examined below – that takes into consideration the impact of domestic amendments, subsequent to the conclusion of the relevant treaty, on the interpretation and application of art. 3(2). There is extensive Canadian case law concerning art. 3(2). However, these judgments mostly focus on the interpretative process underlying the choice of the exact domestic definition<sup>84</sup> and do not deal with the limits deriving from the treaty context (i.e. the possibility to apply a contextual definition). Case law concerning beneficial

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International, Third Edition, 1997, pp. 215 – 216. This topic will be further analysed below.

<sup>83</sup> Wage tax fictions: HR, 5 September 2003, nrs. 37 651 and 37 670, BNB 2003/379 and BNB 2003/381; Interest fiction case: HR 18 June 2004, nr. 39 385, BNB 2004/314.

<sup>84</sup> For an overview, see Kandev, M. N., *Tax Treaty Interpretation: Determining Domestic Meaning Under Article 3(2) of the OECD Model*, in Canadian Tax Journal, Vol. 55 (2007), No. 1, pp. 40 – 67;

ownership mostly deal with the need to delineate the applicable notion in the specific case at issue<sup>85</sup>.

In this paragraph the interpretative position of the Dutch Supreme Court is illustrated on the basis of the case law concerning the attribution of notional wage (article 12a of the Dutch Wage Tax Act 1964).

In 1997 the Netherlands has introduced a ‘typical wage rule’ (in Dutch: ‘gebruikelijk loon regeling’) which applies to substantial shareholders of companies where they carry on some activities without receiving an appropriate salary, if any. This Dutch rule attributes a fictitious salary to the substantial shareholder on the presumption that an employment relationship exists. The salary should be in accordance with remuneration that the employee would have been received under ‘normal conditions’. Hence the name: the ‘typical wage rule’<sup>86</sup>.

In 2003, the Dutch Supreme Court was called to decide whether the described domestic amendment determined a tax treaty override in two cases<sup>87</sup> concerning the 1970 tax treaty with Belgium based on the OECD Model Convention. Two individuals resident in Belgium were deemed to have been received a salary from Dutch companies.

Prior to 1997, the relevant income could only be taxed as dividends or capital gains by the state of residence according to articles 10 or 13 of the OECD Model Convention.

The amendment to Dutch domestic law determined the application of art. 15 and/or 16 of the OECD Model Convention which respectively attribute the right to tax income from employment and directors’ fees to the source state. Accordingly, the Netherlands had the right to tax.

The Dutch Supreme Court had to decide about the legitimacy of a piece of legislation amended only after the conclusion of the relevant treaty and that had fictitiously qualified a certain income in order to determine the application of a distributive rule favourable to the Netherlands.

The Court firstly highlighted that art. 3(2) of the OECD Model Convention does not exclude the application of fictions for treaty purposes. Taxation of notional income is not in itself conflicting with art. 3(2).

On the contrary, art. 3(2) grants some ‘leeway’<sup>88</sup> to national legislatures. In the case an item of income or capital is rightly allocated, i.e. the appropriate distributive rule is applied on the basis of the very nature of the relevant item of income or capital, the national legislature can rule on ‘the way of levying the

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<sup>85</sup> For an overview, see Van Weeghel, S., General Report, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, Volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, pp. 50 – 52.

<sup>86</sup> The ‘the typical wage rule’ can be found in article 12a of the Dutch wage tax act 1964. The provision was introduced as per 1 January 1997. It has been modified after that introduction, although not substantially.

<sup>87</sup> HR, 5 September 2003, nrs. 37 651 and 37 670, BNB 2003/379 and BNB 2003/381.

<sup>88</sup> The Hoge Raad clearly recalls paragraph 12 of the OECD Commentary to art. 3(2).



tax, the determination of the time at which the income is taken into account, the determination of the amount of the income, and the way of calculation'<sup>89</sup>.

To this extent, and in any case within the limits generally established by art. 3(2), national legislation can introduce fictions and tax lump-sum.

In principle, therefore, the fact that art. 15 of the treaty with Belgium (substantially corresponding to art. 15 of the OECD Model Convention) used the terms 'salaries, wages and other similar remuneration derived by'<sup>90</sup>, which were not defined within the treaty text, did not impede taxation of fictitious wage which was deemed to be derived from a fictitious employment. The same was true for art. 16 of the treaty with Belgium (only partially corresponding to art. 16 of the OECD Model Convention). The terms 'bonus schemes, attendance remunerations and other remuneration derived by'<sup>91</sup> were not defined within the treaty text.

Nevertheless, the posterior introduction of a 'typical wage rule' led to a shift in the allocation of the taxing power as originally established through the relevant treaty. The Dutch legislation at issue is based on a qualification of income which does not correspond to its very nature. It allows taxation of an unreal wage and impede the future taxation of real capital gains or dividends. The 'typical wage rule' determined the application of art. 15 and/or art. 16 of the treaty with Belgium while, absent the rule, articles 10 or 13 of the treaty at issue (corresponding to articles 10 and 13 of the OECD Model Convention) would apply in favour of the state of residence.

Since the introduction of the 'typical wage rule' caused a unilateral extension of the Netherlands taxing power by altering the original commitments as established at the moment of the conclusion of the treaty, the Dutch Supreme Court did not allow the Netherlands to apply this legislation for treaty purposes. This interpretative approach has become fundamental in the case law of the Dutch Supreme Court concerning the attribution of fictitious income. In general terms, it is possible to say that point of reference for the Dutch Supreme Court is the very nature of an item of income or capital 'as determined by the source from which it arises'<sup>92</sup>. It is on the basis of the very nature of the relevant item of income or capital that the applicable distributive rule needs to be individuated. The pertinent distributive rule determines the limits to an ambulatory interpretation on the basis of the general principles expressed within the OECD Commentary to art. 3(2).

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<sup>89</sup> HR, 5 September 2003, nr. 37 651, par. 3.4.1: '*de wijze van heffing, de bepaling van het tijdstip waarop die inkomsten in aanmerking worden genomen, de bepaling van hun omvang en de wijze van hun berekening*'. The HR uses the same wording in HR, 5 September 2003, nr. 37 670 in paragraph 3.4.1.

<sup>90</sup> In Dutch: '*Salarissen, lonen en andere, soortgelijke beloningen verkregen door*'.

<sup>91</sup> In Dutch: '*Tantièmes, presentiegelden en andere beloningen verkregen door*'.

<sup>92</sup> See par. 3.4.1 of both 5 September 2003 judgments: '*zoals die bepaald wordt door de bron waaruit zij ontstaan*'.



According to the Dutch Supreme Court, an ambulatory interpretation is first of all limited by the need, which is highlighted in paragraph 13 of the OECD Commentary to art. 3(2), to preserve the ‘permanency of commitments’ that the contracting states undertook at the moment of the conclusion of the relevant treaty. Thus, the Dutch Supreme Court excludes that the contracting states can make the relevant tax treaty partially inoperative by changing the meaning of treaty terms through subsequent amendments of domestic law.

More specifically, this means that a contracting state cannot change a domestic law definition so that its application for treaty purposes determines the application of a distributive rule which is not that one applicable on the basis of the very nature of the income or capital at issue and this shift in the application of the appropriate distributive rule determines a unilateral extension of the taxing power of the amending contracting state.

In substance, a tax treaty override occurs when the amended domestic law determines a shift in the application of the pertinent distributive rule so that the distributive rule applicable according to the new definition attributes taxing power to the amending contracting state while if the pertinent distributive rule had been applied the taxing power would have been recognized to the other contracting state.

Furthermore, the Dutch Supreme Court connects the need to preserve the ‘permanency of commitments’, as expressed in paragraph 13 of the Commentary to art. 3(2), with the provision ‘unless the context otherwise requires’. According to the Dutch Supreme Court, the context includes the domestic law of the contracting states at the moment the treaty is applied. This implies that the principle of reciprocity is respected when the amendment adopted in a contracting state corresponds to a change that had already been made in the other contracting state. As a consequence, the Dutch Supreme Court ruled that, even when a domestic amendment has determined a unilateral shift of the taxing power, a breach of the good faith principle (and, therefore, a treaty override) should be excluded if an equal amendment had already been adopted in the other contracting state. In this case the balance between the treaty parties can be considered restored.

In the following part of this chapter (‘part B’) the case law concerning exit taxation will be examined. The same reasoning underlying the case law about notional income has been applied by the Dutch Supreme Court in order to verify whether cases of tax treaty override occurred with reference to two Dutch exit tax regimes: the regime concerning pension claims and the regime concerning substantial shareholdings.

## PART B - Exit tax regimes and possible cases of tax treaty override

### 1. Introduction: a further development in the interpretation of art. 3(2) of the OECD Model Convention with a focus on exit taxation

The second part of this chapter has the purpose to further develop the interpretative process underlying the individuation of cases of tax treaty override. The previous part has established the central role of art. 3(2) as general interpretative clause within the OECD Model Convention. Moreover, the high importance of art. 3(2) with reference to the possibility of introducing and amending domestic fictions has been proved. The OECD Model Convention does not expressly contemplate the use of fictions. However, it has been demonstrated that they are admissible under art. 3(2) to the extent that the relevant limits – mostly the limits deriving from the treaty context – are respected.

The analysis of fictitious income will be further developed in this part of the chapter. The Dutch Supreme Court consistently applied the reasoning underlying the notional income case law to the Dutch exit tax regimes concerning pension claims and substantial shareholdings. The court reached two opposite solutions exactly on the basis of the consequences determined by the re-characterization of income on the applicability of the relevant distributive rule. The same approach has been followed in a judgment of the Belgian Supreme Court specifically dealing with exit tax on pensions<sup>93</sup>. Again, the Dutch case law at issue, together with the judgment of the Belgian Supreme Court, is – to my knowledge – the only case law dealing with an analysis of exit tax regimes on the basis of a deep examination of art. 3(2) and its incidence on the application of fictions under

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<sup>93</sup> This judgment will not be dealt with in details in this chapter. See De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 279: ‘The Belgian Supreme Court confirmed a decision of the Court of Appeal of Brussels which held that Arts. 26 and 27 VC preclude Belgium from introducing two fictions in its internal law (i.e. a deemed payment and a deemed residence provision, Art. 364 bis BITC) several years after entering into the 1964 Belgium – France tax treaty with the purpose to override the treaty, i.e. to claim back tax jurisdiction over pensions which Belgium has relinquished to France under the Pension Article of the tax treaty.’ In addition on p. 281: ‘In summary, according to this jurisprudence of the Belgian and Dutch Supreme Courts where changes in domestic law result in a shift in the allocation of taxing rights and in potentially unresolved double taxation and accordingly seriously impair the balance and the primary objective of the treaty, the exception laid down in Art. 3(2) (“unless the context requires otherwise”) as well as the principle of good faith set forth in Art. 31 VC and the provisions of Arts. 26 and 27 VC prevent a Contracting State from effectively applying its new domestic law definitions or fictions for purposes of interpreting undefined treaty terms. The Dutch Hoge Raad made, however, an important provisio. Where a Contracting State after signing the treaty widened the scope of its domestic law so that its domestic law has become equivalent to that of the other Contracting State (that may also have changed its domestic law after signing the treaty), changes in domestic law are to be given effect for treaty purposes, even if that results in a shift of allocation of taxing rights.’

tax treaties. Different exit tax regimes will be analyzed in chapter six where the then developed ‘interpretative model’ will be concretely applied to the U.S. exit tax regime, the Dutch exit tax regime concerning the transfer of companies and the so-called ‘re-entry charge’ applied in the UK.

## 2. Exit tax and the OECD Model Convention

The analysis concerning exit tax and the possibility that a treaty override is realized through its unilateral introduction is particularly difficult. At the origin of all the interpretative problems there is the fact that the OECD Model Convention was not conceived to cover this kind of legislation. Art. 13(5) very simply and clearly establishes that, when capital gains are realized through alienation, ‘only’ the state of residence at that moment (when capital gains are realized) can tax. The provision at issue does not protect the right of the state of source to tax capital gains that accrue there before realization. Analogously, under art. 18 ‘only’ the state of residence can tax pensions and other similar remuneration when they are paid.

Certainly, it cannot be disputed the fairness of taxing income in the jurisdiction where it accrued. However, this right is simply not protected by the OECD Model Convention. For this reason, as generally happens with anti-avoidance or anti-evasion provisions, states acted unilaterally. Exit tax regimes are now widely diffused. The Court of Justice of the European Union has recognized the right of the source state to tax capital gains accrued during the taxpayer’s residence there. However, member states cannot levy exit taxes immediately upon emigration. The principle of proportionality, under the rule of reason of the Court of Justice, has imposed – always with regard to individuals<sup>94</sup>, at discretion of the taxpayer when the transfer concerns companies<sup>95</sup> – to postpone the collection of exit taxes until the moment of actual realization. In order to preserve the taxing right

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<sup>94</sup> ECJ 11 March 2004, C-9/02 *de Lasteyrie du Saillant* [2004] ECR I-2409; ECJ 07 September 2006, C-470/04 *N* [2006], ECR I-7409. See De Pietro, C., *Exit Tax: Fiscal Territoriality and Company Transfer*, in *European Tax Studies* (ste.seast.org/en), No 1/2009; De Pietro, C., *Compatibilità comunitaria di exit tax su partecipazioni rilevanti*, in *Rassegna Tributaria* n. 4/2006, pp. 1377 – 1400.

<sup>95</sup> CJEU 29 November 2011, C-371/10 *National Grid Indus*. In paragraphs 70, 71 and 72 the Court stated:

‘70. ... as the Advocate General observes in point 69 of her Opinion, ... the asset situation of a company may appear so complex that an accurate cross-border tracing of the destiny of all the items making up the company’s fixed and current assets until the unrealised capital gains incorporated into those assets are realised is almost impossible, and that such tracing will entail efforts representing a considerable or even excessive burden for the company in question.

71. It thus cannot be ruled out that the administrative burden that would be entailed by the annual return suggested by the Commission, which would necessarily relate to every asset in respect of which a capital gain was established at the time of the transfer of the place of effective management of the company concerned, would give rise as such, for that company, to a hindrance to freedom of

of the state of source, the Court of Justice has recognized the legitimacy of a preserving assessment. The amount of the due tax is assessed upon emigration while the payment is postponed until the moment of actual realization. EU law allows the state of departure to levy a tax on capital gains when the taxpayer is no longer resident of that state. Actually, in the N. case, in which the Dutch exit tax on substantial shareholding was at issue, the Court even stated that this technique of taxation based on a preserving assessment can be considered compliant with the principle of territoriality underlying the OECD Model Convention <sup>96</sup>. Nevertheless, a part from the ‘evolution’<sup>97</sup> that the principle in question has had in the interpretation of the Court of Justice, within the context of the OECD Model Convention the principle of territoriality is protected to the extent that double taxation needs to be avoided. Consequently, it is a limit to the liability of a resident taxpayer only to the extent this is expressly established by the treaty. In short, the OECD Model Convention does not protect a general right to tax of the state of source. It is emblematic that within the text of the OECD

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*establishment that would not necessarily be any less harmful to that freedom than the immediate recovery of the tax debt corresponding to the capital gain.*

72. *In other situations, on the other hand, the nature and extent of the company's assets would make it easy to carry out a cross-border tracing of the individual assets for which a capital gain was ascertained at the time when the company transferred its place of effective management to another Member State.’*

Consequently, the Court concluded in paragraph 73 : ‘*In those circumstances, national legislation offering a company transferring its place of effective management to another Member State the choice between, first, immediate payment of the amount of tax, which creates a disadvantage for that company in terms of cash flow but frees it from subsequent administrative burdens, and, secondly, deferred payment of the amount of tax, possibly together with interest in accordance with the applicable national legislation, which necessarily involves an administrative burden for the company in connection with tracing the transferred assets, would constitute a measure which, while being appropriate for ensuring the balanced allocation of powers of taxation between the Member States, would be less harmful to freedom of establishment than the measure at issue in the main proceedings. If a company were to consider that the administrative burden in connection with deferred recovery was excessive, it could opt for immediate payment of the tax.’ See De Pietro, C., *Exit tax societaria e le garanzie della proporzionalità: di fatto, una questione rimessa agli Stati membri*, in *Rassegna Tributaria*, No. 5/2012, pp. 1337 – 1370.*

<sup>96</sup> ECJ 07 September 2006, C-470/04 N [2006], ECR I-7409, paragraphs 41 – 46.

<sup>97</sup> See De Pietro, C., *Exit Tax: Fiscal Territoriality and Company Transfer*, in *European Tax Studies* (ste.seast.org/en), paragraph 3: ‘It is worth noting that in its most recent judgments, the Court applies the principle of territoriality in connection with both tax system coherence and allocation of taxing power with a lack of clarity. The three concepts (territoriality, coherence and allocation of taxing power), on which a unique mandatory requirement of public interest has been based, have hardly become distinguishable from each other.

*The most plausible explanation of their part in the Court's reasoning, also in the light of its case law, is that the principle of territoriality is applied in its original formulation as a criterion that limits worldwide taxation by the residence state and avoid double taxation. Thus, territoriality has the function of assuring a “balanced” allocation of taxing power, whose coherence is the “domestic” condition.’*

Model Convention and its Commentaries the principle of ability to pay is taken into consideration exclusively in the OECD Commentary to art. 18<sup>98</sup> to justify taxation of pensions in the state of residence.

The position of the Court of Justice has certainly contributed to the adoption of fictions underlying exit tax regimes. After all, the Court has indirectly accepted that emigration amounts to an act of disposal.

States do not (and cannot) remain indifferent to the effects of international treaties in case of emigration. This is exactly because the transfer of residence is not contemplated by the OECD Model Convention and it can actually cause – for the state of source – a loss of taxes on income accrued before the transfer.

### **3. Dutch exit tax on substantial shareholding: the legitimacy of a preserving assessment in the light of the treaty context**

The Netherlands introduced an exit tax on substantial shareholdings in 1997. Following the modification of the Dutch Income Tax Act in 2001, art. 4.16 (1) (h) establishes that ‘alienation’ amounts to the status of being no longer a resident taxpayer. In connection, art. 4.46 of the Dutch Income Tax Act specifies that in case of alienation – as meant in art. 4.16 (1) (h) – the moment of realization is considered to be the moment that is immediately preceding the moment of no longer being a resident taxpayer.

It is also important to specify that with regard to the exit tax applied to individuals substantial shareholders the Dutch legislation grants a preserving assessment which determines the amount of the tax due at the moment of the transfer but at the same time grants a deferral of the payment until the moment of actual realization within ten years from the transfer. If the ten years period expires without the actual realization having taken place, the Netherlands waives its taxing right. Thus, the preserving assessment grants to the Netherlands the right to tax – at least for a certain period of time – capital gains which have not been actually realized at the moment of emigration.

In February 2009 the Dutch Supreme Court decided three cases concerning the compliance of the Dutch exit tax legislation with tax treaties based on the OECD Model Convention<sup>99</sup>. The cases specifically regarded three individuals who held a substantial shareholding in a Dutch company and transferred their tax residence to Belgium, England and the United States. It is important to specify that in the cases at issue no question of tax avoidance was arisen. Highly probably, this would have had consequences on the reasoning of the Court.

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<sup>98</sup> A general reference to the ability to pay principle is also contained in paragraph 1 of the OECD Commentary to art. 24.

<sup>99</sup> HR 20 February 2009, No. 42 701, BNB 2009/260 (Belgium); HR 20 February 2009, No. 43 760, BNB 2009/261 (United States); HR 20 February 2009, No. 07/12314, BNB 2009/262 (United Kingdom).

In the following, the case with Belgium will be used as point of reference. The reasoning in the other cases is substantially the same.

Art. 13(4) of the 1970<sup>100</sup> treaty between the Netherlands and Belgium followed art. 13(5) of the OECD Model Convention and, therefore, granted the state of residence the right to tax capital gains at the moment of alienation.

The Dutch Supreme Court followed the Opinion of the Advocate General Wattel and excluded that the Dutch legislation had realized a treaty override.

It is important to highlight that the Dutch case law concerning exit taxation follows the fundamental principles enucleated within the judgments concerning notional income.

Although this point remained implicit in the judgment of the Dutch Supreme Court, the Advocate General Wattel in his Opinion highlighted that from the Dutch Supreme Court case law it is clear that the starting point in the evaluation of a possible case of treaty override is the allocation of the taxing power as determined at the moment of the conclusion of a tax treaty. A new amended piece of legislation can introduce a deeming provision to the extent that the limits established by art. 3(2) of the OECD Model Convention are respected. In any case, an amended law cannot shift the allocation of the taxing power as originally established by the contracting parties and determine the application of a distributive rule which grants the taxing power to the amending state.

The applicable distributive rule is the one concerning the item of income or capital at issue considering its very nature as resulting from its source.

By amending its exit tax legislation on substantial shareholding the Netherlands has not re-characterized the taxable capital gains. The Dutch legislation has, therefore, not modified the application of the relevant distributive rule. Art. 13(4) has remained applicable.

However, art. 13(4) expressly referred to capital gains derived from alienation. A crucial interpretative issue was, therefore, whether income accrued but not yet realized was covered by art. 13(4) of the relevant tax treaty. This required to establish whether the concept of alienation, as used within the text of art. 13(4), also covered cases of deemed alienation. The Advocate General Wattel emphasized that this analysis did not involve a pure fiction because the taxable income, although not yet realized, existed as an economic value<sup>101</sup>.

The term '*alienation*' was not defined within the relevant treaty. Art. 3(2), therefore, applied. The term could have the meaning it had within domestic law, unless the context otherwise required.

According to the Advocate General Wattel, whose argument was explicitly accepted by the Hoge Raad, this was a case where the context required

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<sup>100</sup> The new tax treaty between Belgium and the Netherlands entered into force on the 31<sup>st</sup> December 2002.

<sup>101</sup> This specification recalls the distinction that Wattel and Marres made between fictions which are not based on an economic value and fictions that, instead, are like, for example, lump-sum. See Wattel, P. J. and Marres, O., *Characterization of Fictitious Income under OECD-Patterned Tax Treaties*, in *European Taxation*, Vol. 43 (2003), No. 3, p. 69.

otherwise. In his view, it could be inferred from paragraphs 5 to 9 of the OECD Commentary to art. 13 that art. 13 encompassed a broad notion of alienation which also included deemed realization. In particular, paragraph 8 of the OECD Commentary refers to any case of realization of capital gains. It states: *‘Special circumstances may lead to the taxation of the capital appreciation of an asset that has not been alienated. This may be the case if the value of a capital asset has increased in such a manner that the owner proceeds to the revaluation of this asset in his books. Such revaluation of assets in the books may also occur in the case of a depreciation of the national currency. A number of States levy special taxes on such book profits, amounts put into reserve, an increase in the paid-up capital and other revaluations resulting from the adjustment of the book-value to the intrinsic value of a capital asset. These taxes on capital appreciation (increment taxes) are covered by the Convention according to Article 2.’* From the Advocate General’s point of view this implies that each Contracting State is allowed to establish in which cases capital gains realization can take place. These arguments were completely accepted by the Dutch Supreme Court which explicitly stated that the sentence *‘[g]ains from the alienation of any property’* under art. 13(4) of the treaty between Belgium and the Netherlands also covered cases of realization other than alienation. The Hoge Raad explicitly stated: *‘4.3.2. Under Article 13, § 4 of the Treaty - unless § 5 of that Article applies is applicable - the gains from the alienation of shares are taxable only in the State of which the alienator is a resident. Article 13, § 4, is included in the Treaty on the basis of the model of Article 13, § 5 (until 2003: § 4) of the OECD Model Convention. From the official commentary to article 13 of the OECD Model Convention, as cited in section 4.13 of the Opinion of the Advocate General, it must be inferred that with the use of the term ‘gains from the alienation of any property’ it is not intended to exclude that a state - with a similar result for the allocation of taxing rights between the contracting states - for the taxation of capital gains alludes to an ascertained accrual of value which has not been effectuated through alienation.’*<sup>102</sup>

Both the Advocate General and the Dutch Supreme Court strengthened their position by emphasizing that the Dutch legislation at issue taxes exclusively capital gains accrued during the period of tax residence in the Netherlands. Furthermore, the Netherlands grants a step up at the moment of immigration.

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<sup>102</sup> Judgment No. 42.701, 20 February 2009. The translation is of the present author assisted by a mother tongue tax lawyer. The following is the original Dutch version: *‘4.3.2. Ingevolge artikel 13, § 4, van het Verdrag zijn - tenzij § 5 van dat artikel van toepassing is - de voordelen uit de vervreemding van aandelen slechts belastbaar in de Staat waarvan de vervreemder inwoner is. Artikel 13, § 4, is in het Verdrag opgenomen naar het model van artikel 13, § 5, (tot 2003: § 4) van het OESO-modelverdrag. Uit het officiële commentaar bij artikel 13 van het OESO-modelverdrag, aangehaald in onderdeel 4.13 van de conclusie van de Advocaat-Generaal, moet worden afgeleid dat niet beoogd is om door het bezigen van de term ‘gains from the alienation of any property’ uit te sluiten dat een staat - met een soortgelijk gevolg voor de verdeling van de heffingsrechten tussen de verdragsstaten - voor de heffing van vermogenswinst aanknoopt bij een geconstateerde vermogensaanwas die niet door vervreemding tot uitdrukking is gekomen.’*



Finally, double taxation is avoided through a reverse credit which is recognized when the state of destination taxes capital gains at the moment of their realization. There is an aspect concerning the judgment at issue that needs to be emphasized. The Court did not clarify the relationship between the fiction concerning the moment of realization just before emigration and the relevant tax treaty. The Dutch Supreme Court, which agreed with the Advocate General, exclusively explained that the operation of the fiction, which in principle prevents the application of the tax treaty, was not sufficient to state the legitimacy of the Dutch exit tax regime.

In this respect, it is interesting to evaluate a passage of the Advocate General's Opinion. Implicitly recalling the Hoge Raad case law on notional income, the Advocate General pointed out that art. 3(2) of the OECD Model Convention assures some leeway to the contracting state which introduces fictions or lump-sum subsequently to the conclusion of a tax treaty. In paragraph 4.45 of its Opinion the Advocate General stated: *'...Now that it cannot be argued that the unrealized (but real) capital gains that can be allocated to the Dutch ownership period are by their very nature not allocated to the Netherlands to tax, art. 3(2) of the 1970 treaty with Belgium leaves in my view to the Netherlands the right to tax the accrual of value with the application of national rules about the way of taxing (preserving assessment), the time of taxable moment (at the end of the Dutch residency) and calculation.'*<sup>103</sup>

It is worth noting that when referred to the time of taxable moment the Advocate General mentioned *'the end of the Dutch residency'* and not the moment just before emigration.

#### **4. Dutch exit tax on pension claim: a case of tax treaty override caused by a re-characterization of income**

A few months after the decisions concerning the levy of an exit tax on substantial shareholding were delivered, the Dutch Supreme Court ruled about the compliance with tax treaties of exit tax on pensions. The three decisions, issued in June 2009, concerned the levy of an exit tax on the pension rights accrued in the Netherlands by individuals that transferred their tax residence abroad. In the cases at issue the relevant treaties had been concluded by the Netherlands

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<sup>103</sup> Opinion of the Advocate General Wattel, No. 42701, released on the 4<sup>th</sup> of October 2006, paragraph 4.45: *'... Nu niet gezegd kan worden dat de ongerealiseerde (maar reële) aan de Nederlandse bezitsperiode toe te rekenen vermogenswinsten naar hun aard niet aan Nederland ter heffing zouden zijn toegewezen, laat art. 3, paragraaf 2, van het Verdrag met België 1970 Nederland mijns inziens de ruimte om die vermogensaanwas te belasten met toepassing van nationale regels over de wijze van heffing (conserverend), het tijdstip van in aanmerkingneming (bij beëindiging van het Nederlandse inwonerschap), en berekening.'*

The translation is of the present author with the assistance of a mother tongue tax lawyer.



with France<sup>104</sup>, Korea<sup>105</sup> and Philippines<sup>106</sup>. Also in these cases the conclusion of the international conventions preceded the 2001 changes to the Dutch Income Tax Act<sup>107</sup>. With these amendments it was established that in case of emigration of the employee who had received pension rights in the past, the fair market value of the pension rights accrued in the Netherlands was – by way of fiction – considered to be income from employment<sup>108</sup>. This amount was deemed to have been received just a moment before the taxpayer had lost its Dutch residence. The Hoge Raad had to decide whether these amendments were in accordance with the relevant tax treaties or, on the contrary, they had realized cases of treaty override.

In the Netherlands, the granting of pension rights as part of a salary is exempt from wage and income taxes during the employment period. The pension is taxed in the hands of the (retired) employee when the pension is actually paid. This payment includes both the previously paid contributions and the results of the investment.

The anti-abuse rationale of the Dutch exit tax is clear. The contributions paid to the pension funds during the period of residence in the Netherlands are exempted from wage and income tax. Taxation is postponed until pension is actually paid. Emigration clearly disrupts this system. Accordingly, the exit tax is targeted at the claw-back of the tax advantages in case the taxpayer performs some ‘tainted actions’ abroad after the emigration. Such tainted actions include the redemption or the alienation of the pension claims. Accordingly, just like in the cases about substantial shareholders described before, the taxpayer obtains a preserving assessment which determines the amount of the tax due at the moment of the transfer but at the same time grants a deferral of the payment for a period of ten years. If the ten years period expires without any tainted actions taking place, the Netherlands waives its taxing right.

Also in these judgments, starting point of the Dutch Supreme Court is the actual qualification of the income at issue in order to establish which distributive rule is rightly applicable.

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<sup>104</sup> HR 19 June 2009, No. 43 978, BNB 2009/263.

<sup>105</sup> HR 19 June 2009, No. 07/13267, BNB 2009/265.

<sup>106</sup> HR 19 June 2009, No. 08/02 288, BNB 2009/266.

<sup>107</sup> At this point it should be added that the Netherlands had introduced different measures to counter-act the abusive settlement of pension claims in case of emigration before 2001. These measures were based on different mechanisms than the 2001 amendments. These measures have however also been scrutinised by the Dutch Hoge Raad. In two different cases, the Hoge Raad ruled that the introduction of these provisions amounted to tax treaty override, as the Netherlands attempted to tax an income which would have been attributed to the new state of residence as a result of the application of article 18 of the relevant double tax treaties. Compare HR 5 September 2003, No. 37 657, BNB 2003/380 and HR 13 May 2005, No. 39 610, BNB 2005/233.

<sup>108</sup> Article 3.83 of the Dutch Income Tax Act 2001.

The Dutch Income Tax Act qualifies the economic value of the pension claim as income from employment. The Dutch Supreme Court excludes the correctness of this qualification. The relevant sums, in fact, not only include the contributions paid to the pension fund but also the results of the investment. Only the sums which are paid to pension funds could be considered income from employment and consequently taxed under art. 15 of the relevant treaties (art. 16 of the treaty with Korea). However, the Netherlands exempts these sums during the residence of the employees.

Taxing the total value of the pension claim would imply to tax a bigger sum than the effective sum exempted during the residence in the Netherlands.

Taxation of accrued pension claim is not governed by art. 15 (or 16) of the relevant treaties. According to the Dutch Supreme Court only art. 18 (art. 19 of the treaty with Korea) is applicable.

The Dutch Supreme Court does not consider it sufficient to exclude the application of a tax treaty under the provision according to which the pension claim is deemed to have been received just a moment before emigration. The compliance of the Dutch legislation at issue with the applicable tax treaties needs to be evaluated.

Also in this case the Advocate General Wattel, rather than the Dutch Supreme Court, conducts a deep analysis about the possibility that a preserving assessment concerning accrued pension rights could be considered legitimate under article 18 of the relevant treaties (article 19 of the treaty with Korea). According to the Advocate General, both text and context of the international provisions at issue exclude the legitimacy of the Dutch legislation. These treaty provisions follow art. 18 of the OECD Model Convention, according to which *'pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State'*.

The use of the term 'paid' implies, according to the Advocate General, that art. 18 only covers actual payments, as it is confirmed by the OECD Commentary as well.

Although not specifically mentioned by the Advocate General<sup>109</sup>, paragraph 7 of the OECD Commentary to art. 10 states that *'... [t]he term "paid" has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or by custom'*. Similarly, when defining the term 'paid' both paragraph 5 of the Commentary to art. 11 and paragraph 8.3 of the Commentary to art. 12 explicitly mention *'the obligation to put funds at the disposal of the creditor'*.

The Advocate General Wattel, therefore, concludes that art. 18 of the relevant treaties (art. 19 of the treaty with Korea) cannot be applied to accrued (not actually paid) pension rights which include not only the sums conferred to pension funds and exempted under income tax in the Netherlands but also the

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<sup>109</sup> See, however, Wattel, P.J. and Marres, O., *Characterization of Fictitious Income under OECD-Patterned Tax Treaties*, in *European Taxation*, Vol. 43 (2003), No. 3, pp. 67 – 69.

results of the investment. Article 18 (art. 19 of the treaty with Korea) exclusively allows taxation at the moment when the pension is actually paid and, therefore, only in the new state of residence.

These considerations about the role of the term ‘paid’ within art. 18 are not expressed by the Dutch Supreme Court. The court is mostly concerned about the application of art. 18 on the basis of a qualification of income founded on its real nature. Confirming its ruling in the case No. 39.610, issued on the 13<sup>th</sup> of May 2005, the Dutch Supreme Court affirms that a fictitious qualification by law as income from employment cannot exclude the application of art. 18 because only the sums paid by the employer to the employee can be qualified as income from employment. After that moment pension claim can only be taxed according to art. 18. At the same time the application of art. 18 cannot be prevented by the fiction according to which the relevant sums are assumed to be received just a moment before emigration. The Court recalls its decision No. 37.657, issued on the 5<sup>th</sup> September 2003, and states that no deeming provisions about the moment of receipt of the sums can change that art. 18 applies and produces its effects only after emigration when the taxing power is accorded to the state of new residence.

A case of tax treaty override occurred.

## **5. Concluding remarks on exit taxation**

This analysis about exit tax represents a step forward in the construction of the interpretative process underlying the identification of cases of tax treaty override. The examined case law of the Dutch Supreme Court is particularly important for this purpose. It gave us the opportunity to further investigate the reasoning underlying the application of art 3(2) of the OECD Model Convention and, more in general, the way to establish the limits determined by a tax treaty and its context in order to apply amended domestic law. Moreover, further considerations need to be added with regard to the compliance of fictions with the OECD Model Convention.

The two Dutch regimes of exit taxation analyzed in the case law at issue are very similar. Most importantly, both regimes are based on a preserving assessment that avoid actual taxation at the moment of emigration. After all, the Court of Justice of the European Union has consistently held that – at least when the transfer of individuals is at issue– the principle of proportionality excludes the possibility of an immediate taxation upon emigration. The consequence of the application of a preserving assessment at international level is the necessity to verify the compliance with the OECD Model Convention of deemed taxation, i.e. taxation of sums which are not actually at the disposal of the taxpayer.

The core of the interpretative process conducted by the Advocate General Wattel, and shared by the Dutch Supreme Court, stems from the Dutch Supreme

Court case law concerning taxation, through art. 3(2) of the OECD Model Convention, of notional income. The Advocate General Wattel specifies that a difference needs to be drawn between mere fictitious income, i.e. income which is not based on an economic value, and income whose economic value is computable. Capital gains object of a preserving assessment under Dutch law are not yet realized although their economic value exists and is computable. Analogously, the preserving assessment concerning the pension claim applies on an already existing economic value, although the corresponding sum has not yet been received by its creditor. In both cases, therefore, Dutch legislation aims at preserving the right to tax income already existing from an economic point of view but not actually at the disposal of the taxpayer. It is a matter of interpretation to establish whether the relevant international provisions cover this possibility. In the Opinion of the Advocate General Wattel, followed by the Dutch Supreme Court, the Commentary to art. 13(5) of the OECD Model Convention allows taxation of capital gains accrued but not yet realized. Different is the text of art. 18 of the OECD Model Convention which explicitly refers to pension 'paid to' a resident of a contracting state. According to the OECD Commentary the term payment implies the fulfillment of an obligation to put funds at the disposal of the creditor.

The interpretation of the two treaty provisions at issue has lead to two opposite solutions. Art. 13(5) allows the preserving assessment of capital gains accrued although not yet realized while art. 18 exclusively permits taxation of sums actually paid to the pensioner. As a consequence, only the amendment concerning taxation of pension claim upon transfer of the pensioner has realized a treaty override. It is important to go further on this aspect to make clearer the connection of this solution with the Dutch Supreme Court case law concerning notional income. The central point of the Dutch Supreme Court interpretative approach is that when taxation of notional income is introduced its compatibility with existing tax treaties needs to be evaluated according to the very nature of the income or capital at issue as resulting from its source. According to the very nature of the income or capital at issue the rightly applicable distributive rule is individuated. A treaty override occurs when the introduction of a notional income has determined a shift in the application of the right distributive rule so that, through the amendment, the amending state has granted itself the right to tax. This is exactly what happened, according to the Advocate General Wattel and the Dutch Supreme Court, in the cases concerning the taxation of pension claim. When the Dutch Income Tax Act was amended in 2001 a fiction was introduced according to which in case of transfer the pension claim accumulated to a pension fund was deemed to be considered income from employment. This re-characterization of income - in fact - determined a shift in the allocation of the taxing power in favour of the Netherlands. Art. 15 of the OECD Model Convention, which establishes taxation in the state of source, became applicable instead of art. 18, which establishes taxation in the state of residence of the pensioner. Both the Advocate General and the Dutch Supreme

Court emphasized that, according to its very nature, a pension claim cannot be qualified as income from employment because the relevant rights include not only the past exempted contributions to the pension funds but also the results of the investment. Pension claim, therefore, fall within the scope of art. 18 that refers to ‘*pensions and other similar remuneration*’.

According to both the Advocate General and the Dutch Supreme Court, the amendment according to which the pension claim has been re-characterized as income from employment has, therefore, determined a unilateral unlawful extension of the Netherlands taxing rights.

Both exit tax regimes are based on a fiction according to which tax liability arises just a moment before the transfer of residence abroad. As emphasized by the Dutch Under Secretary of State<sup>110</sup>, the purpose of this fiction is to prevent the application of tax treaties and assure taxation in the Netherlands. The legitimacy of this fiction in itself is not denied neither by the Advocate General nor by the Dutch Supreme Court. Both of them, however, expressed the necessity to further analyze the compliance of Dutch legislation with the relevant treaty articles. The legitimacy of the preserving assessment on substantial shareholding and the illegitimacy of the preserving assessment on pension claim did not depend on this fiction but exclusively derived from the interpretation of national and international law. After all, the Dutch Supreme Court could have closed the cases very simply, by stating the non-applicability of the treaty exactly by virtue of the fiction at issue. Nevertheless, the Dutch Supreme Court has not accepted the paradoxical position according to which the parliament can merely introduce a fiction and take away the effects of an international treaty. In the judgments concerning pension claim it has explicitly stated that a fiction cannot modify the moment when a treaty actually produces its effect. Art. 18 applies only after emigration notwithstanding the introduction of a fiction that has the purpose to anticipate the moment when tax liability arises.

There is a tendency of national parliaments to easily introduce fictions or attributes retrospective effects to new legislation in order to obtain the desired effects<sup>111</sup>. After all, the immediate reaction of the Dutch parliament following the judgments on pension claim gives a concrete and clear example of what Vogel has defined as ‘hidden treaty override’. Parliaments often resort to their legislative power to eliminate the undesired effects of a judgment<sup>112</sup>.

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<sup>110</sup> With regard to pension claim, the Advocate General mentions this position in paragraph 5.4. of his Opinion in case 43.978. The position of the legislator can be found in the following parliamentary documents: Kamerstukken II 1999/2000, 26 727, nr. 7 (NnavV), pp. 342–343 and Kamerstukken II 1999/2000, 26 727, nr. 17 (NnavNV), p. 183.

With regard to exit tax on substantial shareholders, the Advocate General mentions this position in paragraphs 4.19, 4.20 and 4.21 of his Opinion in case 42.701. The position of the legislator can be found in the following parliamentary documents: Kamerstukken II 1996/97, 24 761, nr. 7 (Nota naar aanleiding van het verslag), pp. 23–24.

<sup>111</sup> This aspect will become clearer in the following chapter.

<sup>112</sup> See *infra* chapter I.

On the same date of the judgments of the Dutch Supreme Court on pension claim (i.e. 19 June 2009) the Dutch Ministry of Finance issued a press release in which it was stated that it would propose new legislation in order to prevent potential budgetary problems as a result of the cases. The proposal was sent to parliament on 29 June 2009 with the suggestion to attribute to the law retrospective effect as to that date. Both chambers of parliament approved this proposal and accordingly the new legislation came into effect as per 29 June 2009.

The main change was that – in case the Netherlands is not allowed to tax on the basis of a (pre-2001) double tax treaty and the 2009 case law – the preserving assessment is no longer based on the fair market value of the pension claim at the moment of emigration, but on the total amount of pension contributions that have been tax deductible in the past. The idea is that such a ‘recovery of the deduction’ does not amount to a re-characterization that gives rise to tax treaty override. This position is based both on the 2009 cases and on an older case of the Dutch Supreme Court (HR 7 December 2001, nr. 35.231, BNB 2002/42). It is important to add that the ‘recovery of the deduction’ is not qualified as ‘wage’ like it was in the past. The recovery is qualified as ‘negative expenses for the provision of income’ (‘negatieve uitgaven voor inkomensvoorzieningen’). This qualification should explicate that the taxation is in fact the recovery of a tax deduction that was granted in the past.

The amendment has been heavily criticized in Dutch literature<sup>113</sup>. However, what is extremely important and needs to be emphasized for our purposes is that, regardless of the content of the amendment, a treaty override is realized through the technique of attributing retrospective effects to a legislation that covers cases actually governed by the previous legislation. By attributing retrospective effects to the new legislation the Dutch parliament has prohibited the application of the Dutch Supreme Court rulings and avoided the possible qualification of cases of treaty override.

To conclude, it is important to emphasize that the fair right of the state of source to tax capital gains accrued during the residence within its jurisdiction should be clearly established within the OECD Model Convention.

The legislative solution could be quite simple. Both contracting states could agree on the possibility that the state of source assesses – with a preserving purpose – the taxable amount at the moment of emigration. In case of pension the preserving assessment could concern exclusively the sums deducted during the tax residence in the state of origin.

An exit tax could be collected in the hands of previous residents at the moment of actual realization of capital gains or, in case of pension, when the pension starts to be paid or the pension claim is redeemed.

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<sup>113</sup> See, for example, Kemmeren, E.C.C.M., *Exitheffing bij pensioenen: Financiën is hardleers*, in *Weekblad Fiscaal Recht*, Vol. 138 (2009), No. 6820, pp. 881– 888.

The provision should also take into consideration possible depreciations at the moment the tax is collected as well as interests accrued after emigration.

The practical difficulties concerning this solution would not be different than those already existing: a periodic exchange of information between the two states as well as a periodical declaration by the taxpayer confirming the ownership of the assets or that the pension claim has not been redeemed.

It is important to point out that a solution based on immediate taxation by the state of source upon emigration would not be compliant with EU law. Anyway, the same policy that has led the Court of Justice of the European Union to recognize the possibility to postpone the payment of an exit tax is, indeed, pertinent on an international level as well. Tax neutrality upon emigration of both companies and individuals favours economy (directly or indirectly – as in case of pensioners who move to another state) and should, therefore, be facilitated.

It is interesting to note that the Netherlands in most of its recent tax treaties has introduced a provision according to which in case of redemption of the pension claim after emigration the state of source has – under specific conditions – the right to tax the paid lump sum<sup>114 115</sup>.

Anyway, in 2011 the Netherlands has officially changed its policy about pension taxation<sup>116</sup>. The Netherlands intends to agree with its treaty partners taxation at source and to abandon definitively the OECD policy in this respect.

## **6. Concluding remarks: some outcomes about the development of an ‘interpretative model’**

Art. 3(2) of the OECD Model Convention has a central role when cases of tax treaty override need to be individuated. This is a general clause that regulates the interpretation of terms which are used within a tax treaty but are not defined therein. Therefore, art. 3(2) establishes the application of domestic definitions, unless the treaty context otherwise requires.

One of the first important points that have been clarified about the provision at issue is that its application is mandatory every time a term used within a tax treaty is not defined within its text.

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<sup>114</sup> See, for example, the treaty with Belgium concluded in 2001. Article 18 of the treaty between Belgium and the Netherlands has already been object of an Hoge Raad judgment issued on the 15<sup>th</sup> of April 2011 (BNB 2011/160). The Hoge Raad has explicitly excluded that the preserving assessment concerning pension claim (including past contributions to the pension fund and results of the investment) breaches art. 18 of the treaty and, therefore, the principle of good faith, when one of the situations contemplated by paragraphs 2 and 3 of the article at issue recur.

<sup>115</sup> See Kemmeren, E.C.C.M., *Exit taxation and pensions: tax treaty override?* (Hoge Raad 15 April 2011, BNB 2011/160) to be published.

<sup>116</sup> Notitie Fiscaal Verdragsbeleid 2011.



As specified above, this study follows the position of those authors that consider art. 3(2) *lex specialis* in respect to the Vienna Convention on the Law of Treaties. In fact, the application of art. 3(2) reverts the system based on the primary search for the ‘ordinary meaning’ of a term under art. 31(1) of the Vienna Convention. Only when the treaty context requires otherwise, i.e. it clearly expresses the common intention of the parties, the contextual definition can prevail on the domestic one.

According to the OECD Commentary to articles 23A and 23B of the Model Convention, the state that applies the treaty must follow the definition elaborated by the state of source. In this way art. 3(2) guarantees that the treaty relieving provision coincides with the domestic tax provision. The interdependence between the functioning of art. 3(2) and the general functioning of the OECD Model Convention is clear. Taxation is based on domestic law. Treaty distributive rules have the purpose to limit the application of domestic tax law. Art. 3(2) guarantees that domestic tax law does not exceed the treaty limits. As a consequence, a treaty override occurs when unilaterally, after the conclusion of the relevant treaty, a party to it extends its taxing power so that the domestic taxing provision has a wider scope than the treaty relieving provision.

When it is required by the context, domestic definitions cannot apply or, as emphasized by Vogel they can apply in a mutual relationship with the treaty context. In this case, the domestic taxing provision needs to be applied according to the common intention expressed by the parties through the treaty context. Consequently, the individuation of a tax treaty override needs to be conducted on the basis of an integrated application of domestic law and statements contained in the treaty context.

Tax treaty override can be realized through a breach of art. 3(2) of the OECD Model Convention, although the overridden provision is not art. 3(2) but, indeed, the provision that uses the undefined treaty term. This provision is unilaterally modified through a breach of art. 3(2) which has widened the scope of the domestic taxing provision notwithstanding the limits established by art. 3(2) – including the treaty context. The use of an amended domestic definition that exceeds these limits extends the scope of the domestic taxing provision which becomes wider than the scope of the treaty relieving provision, i.e. the provision that uses the undefined treaty term.

In connection with art. 3(2), both cases of legislative and judicial tax treaty override can occur. Given the structure and functioning of the OECD Model Convention, in general, and of art. 3(2), specifically, cases of judicial treaty override are certainly more probable. Domestic definitions are, as a rule, adopted to be applied for domestic purposes only. It cannot be said that a tax treaty limits the contracting state sovereignty in order to amend these definitions. State sovereignty is, however, limited in order to apply amended domestic definitions for treaty purposes in case of a conflict. Art. 3(2), as an interpretative clause, *determines* the application of domestic definitions, in principle destined to apply within the national system, for treaty purposes. Art. 3(2) modifies the scope of



domestic definitions and actually extends their scope for treaty purposes. As a consequence, tax treaty override can only occur at the moment when an amended domestic definition is *applied* in contrast with the limits established by art. 3(2).

A legislative tax treaty override will be possible only when the scope of domestic law coincides with the scope of tax treaties already at the moment of its adoption. This usually happens by expressing the intention of overriding existing tax treaties. In this case tax treaty override is realized at the moment domestic law is passed by the national legislature.

Art. 3(2) allows an ambulatory interpretation. This means that domestic definitions can be applied for treaty purposes, if the context does not require otherwise, with the meaning they have at the moment the treaty is applied even if these definitions have been amended after the conclusion of the international agreement. Art. 3(2), therefore, determines a partial derogation from both art. 26 of the Vienna Convention, which establishes the *pacta sunt servanda* rule, and the following art. 27 according to which a state cannot justify a breach of a treaty on the basis of its national law. This derogation is, nevertheless, only partial. As specified in paragraph 13 of the OECD Commentary to art. 3, ‘... the wording of paragraph 2 [of art. 3] provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).’

A national definition, as amended after the conclusion of a treaty, can apply only to the extent that the balance originally established by the contracting parties is not disrupted. According to the majority of the authors who wrote on this topic, this limit is something inherent in the fact that art. 3(2) is a treaty provision and, therefore, it cannot disrupt the balance underlying the treaty itself. This has direct effects on the coordination between the treaty relieving provision and the domestic tax legislation.

The outcomes of this analysis are clearly reflected in the above examined case law of the Dutch Supreme Court either with reference to notional income and with reference to exit tax. When investigating whether a case of tax treaty override has occurred, first of all the rightly applicable distributive rule needs to be individuated. This individuation needs to be based on the very nature of the income or capital at issue as resulting from its source. If a contracting state, when amending domestic law, recharacterizes the relevant income or capital in order to apply a distributive rule which assures itself the taxing power and it is not the distributive rule originally applicable on the basis of the very nature of the income or capital at issue, a case of tax treaty override is realized. Tax treaty override is, therefore, based on a change to domestic law that unilaterally extends the taxing right of the amending contracting state by determining a shift in the allocation of the taxing power as originally established by the contracting parties.

The only aspect that, in my opinion, is not compliant with the principles of reciprocity and legitimate expectations – notwithstanding the above expressed positions of both the Dutch Supreme Court and the authors Wattel and Marres, concerns the possibility to exclude the illegitimacy of a treaty override when a similar amendment had already been introduced by the other contracting state. Agreeably, De Broe has pointed out: ‘... there is a tempting logic to agree with the Court [the Dutch Supreme Court] as to the use of the domestic law meaning of a term that has been amended after the entry into force of the treaty to interpret undefined treaty terms. If because of subsequent changes in the domestic law of the States, such laws are the same, the treaty balance is restored, the principle of reciprocity – a cornerstone of bilateral tax treaties – is respected and concordant interpretation is achieved. However, there is a downside to such logic. The Court’s dictum sounds like an open invitation to retaliation measures allowing one State to respond by a treaty override to an earlier treaty override by the other State and in the Court’s logic both treaty overrides would have effect under the treaty.’<sup>117</sup>

In addition, it needs to be emphasized that the position according to which a tax treaty override can be legitimized on the basis of a previous tax treaty override does not take at all into consideration the consequences that this situation can have on taxpayers. As it will be further emphasized in this study, the possibilities of taxpayer’ protection in case of treaty override are extremely limited. States cannot simply realize two cases of treaty overrides on the basis of a sort of implicit mutual acceptance of illegitimate amendments.

Finally, it is important to emphasize that a mere fiction cannot be unilaterally introduced to prevent the application of an international treaty. The Dutch case law on exit tax has offered the example of fictions that modify the scope of tax treaties by anticipating the moment when tax liability arises. More often the scope of a tax treaty is modified by introducing fictions that are based on deemed residence, i.e. the taxpayer is deemed to be resident in the state that claims taxing power although no real connection exists with this state<sup>118</sup>. This topic will be dealt with in the following chapter when the relationship between CFC legislation and the OECD Model Convention will be analyzed. However, an important aspect can already be pointed out in this chapter.

Domestic legislation can be founded on deemed residence. Nevertheless, these provisions can be considered compliant with the OECD Model Convention only to the extent that they can be included among ‘any other criterion of a similar nature’ according to art. 4(1) of the OECD Model Convention. This provision is commonly interpreted as having a substantive nature, i.e. including substantive connecting criteria<sup>119</sup>.

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<sup>117</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 282.

<sup>118</sup> Concrete examples will be given in the following chapters.

<sup>119</sup> See Widrig, M., *The Expression “by Reason of His Domicile, Residence, Place of Management ...” as Applied to Companies* (Chapter 8), in Maisto, G. (editor), *Residence of Companies*

Mere fictions – i.e. fictions that are not based on any real nexus with a state – cannot be considered legitimate criteria to determine tax residence for treaty purposes. Taxpayers liability cannot be completely disconnected from an actual nexus with the taxing state.

According to Widrig ‘[i]n case a country introduces deemed residence rules, it has to secure that the new connection criteria is in line with the international obligations entered with other countries. In terms of the OECD MC, this means that the connecting criteria have some local connection to the territory...’<sup>120</sup>

Jeffery is also of the opinion that ‘[t]he concept of residence should be based on the satisfaction of clearly identifiable objective criteria in order to provide the certainty which is essential for the efficient conduct of economic activity.’<sup>121</sup>

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*under Tax Treaties and EC Law*, EC and International Tax Law Series, Vol. 5, IBFD, 2009, p. 286.

<sup>120</sup> Widrig, M., *The Expression “by Reason of His Domicile, Residence, Place of Management ...” as Applied to Companies* (Chapter 8), in Maisto, G. (editor), *Residence of Companies under Tax Treaties and EC Law*, EC and International Tax Law Series, Vol. 5, IBFD, 2009, p. 286.

<sup>121</sup> Jeffery, R. J., *The Impact of State Sovereignty on Global Trade and International Taxation*, Series on International Taxation (No 23), Kluwer Law International, 1999, p. 111.

## Chapter V

### *Domestic anti-abuse rules and tax treaty override*

#### **1. Introduction: the relationship between domestic anti-abuse rules and tax treaty provisions**

A study aimed at individuating the interpretative process underlying the detection of cases of tax treaty override cannot set aside the issue concerning the relationship between domestic anti-abuse provisions and treaty provisions. This is true not only for the importance of the topic in itself but also because the examination of the relationship between domestic anti-abuse rules and treaty provisions permits to deal with the inevitable question concerning the possibility to derogate from the original international agreement to safeguard a specific purpose of domestic legislation, i.e. to curb tax avoidance and tax evasion.

Can treaty abuse justify a tax treaty override? Can states be considered allowed to pursue their own interests, when perceived as very important, although this would disrupt the reciprocity underlying a validly concluded international treaty?

This matter entails a particularly delicate interest, i.e. the safeguard of national taxing power. The need of preserving taxation, mostly against cases of abuse, has often driven states towards a re-extension of their own tax jurisdiction thus realizing cases of tax treaty override. This has certainly been facilitated by the fact that taxes are charged under national legislation.

Indeed, artificial constructions aimed at abusing the benefits guaranteed by a tax treaty cannot be accepted since they erode the national tax base. However, one cannot renounce to analyze the relationship which has been established between treaty provisions and domestic legislation when an international agreement has been validly concluded. This, first of all, implies to establish whether the OECD Model Convention contains a general anti-abuse clause that allows the application of domestic anti-abuse rules even in case of conflict with treaty provisions.

However, when searching for such a clause it is immediately clear that the OECD's approach is not founded on the elaboration of a doctrine that defines when a treaty abuse occurs. The OECD allows the application of domestic anti-abuse rules on the basis of the absence of any conflict with tax treaties which are based on the OECD Model Convention. Only paragraph 9.5 of the OECD Commentary to art. 1 warns: *'It is important to note ... that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was*

*to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.'* The scope and nature of this 'guiding principle' will be analyzed below in this chapter. It is clear, however, that the matter requires a deep investigation about the position of the OECD.

In 1989, the OECD Report on treaty override explicitly excluded that a treaty override could be admitted in case of treaty abuse <sup>1</sup>.

More recently, the OECD has denied the existence of any conflict between national anti-abuse legislation and treaty provisions. The consequence of this position is that many OECD member states apply domestic anti-abuse legislation by emphasizing the purpose of double tax conventions to prevent tax avoidance and evasion as stated in paragraph 7 of the OECD Commentary to art. 1. The result is the application of domestic anti-abuse legislation notwithstanding the actual existence of a conflict with tax treaty provisions.

This chapter will point out that the OECD position based on the absence of conflict between anti-abuse legislation and treaty provisions excludes that the OECD conceives treaty abuse as a justification in order to apply domestic law. The OECD simply denies the existence of any conflict and does not justify the application of domestic anti-abuse legislation on the basis of the anti-avoidance and anti-evasion purposes of tax treaties.

The position of the OECD will be examined to verify whether – in fact – there cannot be a conflict between domestic anti-abuse legislation and double tax conventions. If it is demonstrated that conflicts can arise between domestic anti-abuse legislation and treaty provisions, cases of tax treaty override – based on the application of domestic anti-abuse law that breaches a previously concluded agreement – have to be considered illegitimate. The possibility to apply domestic anti-abuse rules will exclusively depend on the compliance of these domestic rules with international tax treaties. Being this the case, interpretation will have again a fundamental role in order to establish to what extent the relevant distributive rules limit the application of domestic anti-abuse rules.

The analysis will first take into consideration – in general – the relationship between domestic anti-abuse clauses and treaty provisions. Subsequently, the possible existence of a conflict between CFC legislation and the relevant provisions of the OECD Model Convention will be concretely examined. The analysis of national case law will give us the opportunity to verify the application of CFC legislation within specific national systems and to point out – in connection with the second chapter of this study – the effects that the constitutional regulation of the relationship between national and international law has on the application of CFC legislation. Some judgments explicitly mention the correctness of the procedure of national incorporation of the relevant treaty.

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<sup>1</sup> OECD, *Tax Treaty Override*, OECD 1989, p. 5.

## 2. Domestic anti-abuse provisions and tax treaty override

The relationship between international tax treaty provisions and domestic anti-abuse rules (including judicially developed doctrines) is one of the most complex matters that is to be solved when – in general – the relationship between international tax treaties and domestic law is at issue.

Purpose of this paragraph is to analyze whether tax treaty override can occur through the application of domestic anti-abuse rules. As a consequence, the present analysis eventually permits to establish whether abuse of a treaty can justify tax treaty override or – at the opposite – a conflict with a previous treaty does not allow the application of amended domestic anti-abuse rules. If treaty abuse is considered a justification and, therefore, an exception to the illegitimacy of tax treaty override, a general possibility of disregarding treaty provisions exists with no need to verify the actual existence of a conflict between a previously concluded treaty and new domestic anti-abuse rules.

In 1987, the OECD started its studies about base<sup>2</sup> and conduit<sup>3</sup> companies. This has implied a certain development of its position concerning the relationship between domestic anti-abuse rules and treaty provisions (which will be further analyzed in this chapter). The OECD Commentaries have consequently been amended in 1992. In 1998, the OECD Harmful Tax Competition Report<sup>4</sup> recommended, among other things, to remove any ambiguity which was contained within the OECD Commentaries about the compliance of domestic anti-abuse rules and doctrines with the OECD Model Convention<sup>5</sup>. In 2003, the OECD Commentary to art. 1 of the Model Convention was substantially amended.

Notwithstanding the 2003 important changes, the highlighted complexity of the relationship between treaty provisions and domestic anti-abuse rules persists. This mostly depends on the still unclear – and sometimes contradictory – position taken by the OECD in the Commentary to art. 1 of the Model Convention. Paragraph 7 states that tax treaties have also the purpose to prevent tax avoidance and tax evasion.

However, paragraphs 9.2 and 9.3 of the Commentary give a mere description of the positions taken by the OECD member states, without attributing a concrete meaning and scope to the OECD purpose of curbing tax avoidance and evasion. Some states qualify abuse of treaty according to their domestic anti-abuse provisions. The reasoning followed by these states is that abuse of treaties causes a loss of income for the state and, therefore, treaty abuse results in an abuse of domestic law.

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<sup>2</sup> OECD, *Double Taxation Conventions and the Use of Base Companies*, OECD 1987.

<sup>3</sup> OECD, *Double Taxation Conventions and the Use of Conduit Companies*, OECD 1987.

<sup>4</sup> OECD, *Harmful Tax Competition – An emerging Global Issue*, OECD 1998.

<sup>5</sup> OECD, *Harmful Tax Competition – An emerging Global Issue*, OECD 1998, p. 48.

According to the position of other states, abuse of treaty can only be qualified according to treaty provisions as interpreted in the light of the Vienna Convention on the Law of Treaties.

Jeffery highlighted: *‘[a]s States have not been able to agree on a common approach to what is and is not acceptable treaty shopping, it is not surprising that they have sought to exert their sovereignty by applying domestic anti-avoidance measures to curb perceived abuses. Sovereignty and jurisdiction have a pivotal role here since it is sought to impose a national perspective to what is an international matter.’*<sup>6</sup>

This statement needs to be also considered in the light of the fact that the OECD Model Convention does not contain any provision expressly allowing states to deny treaty benefits in case of abuse. When the precondition concerning tax residence, which defines the scope of the convention, is met there are no formal rules that deny taxpayers’ treaty benefits.

In fact, there is no OECD doctrine in matters of tax treaty abuse. This is the reason why the Commentary to art. 1 concerning the *‘Improper use of the Convention’* is mainly focused on the relationship between national law and treaty provisions. Paragraph 22.1 of the OECD Commentary on art. 1 states: *‘Such rules [mostly “substance-over-form”, “economic substance” and general anti-abuse rules] are part of the basic domestic rules set by domestic tax laws for determining **which facts give rise to a tax liability**; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict ... [emphasis added]’*

In addition, paragraph 9.2 of the Commentary to art. 1 clarifies: *‘As indicated in paragraph 22.1 below, the answer to that second question [whether specific provisions and jurisprudential rules of the domestic law of a Contracting State that are intended to prevent tax abuse conflict with tax conventions] is that **to the extent** these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining **which facts give rise to a tax liability**, they are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule, there will be no conflict between such rules and the provisions of tax conventions [emphasis added]’.*

Here again, structure and functioning of the OECD Model Convention have a central role. As already explained in the previous chapters, tax treaties do not impose taxes. Taxes are charged under the domestic law of one of the contracting states and, therefore, domestic law establishes taxpayers’ liability. Distributive rules restrict (and only sometimes widen) national tax jurisdiction determining consequences also on the liability of taxpayers.

The OECD Commentary allows states to qualify treaty abuse according to their domestic legislation. However, this possibility is based on the alleged absence of a conflict between national rules that establish tax liability and tax treaty distributive rules. This is the fundamental principle underlying the OECD

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<sup>6</sup> Jeffery, R. J., *The Impact of State Sovereignty on Global Trade and International Taxation*, Series on International Taxation (No 23), Kluwer Law International, 1999, p. 99.

policy when the relationship between treaty provisions and national anti-abuse rules is at issue.

‘As a general rule and having regard to paragraph 9.5, there will be no conflict’. This is – again – what paragraph 22.1 of the OECD Commentary to art. 1 states. And paragraph 22.2 in its first part reiterates: ‘... these rules do not conflict with tax conventions...’

In fact, paragraph 9.5 of the Commentary to art. 1 is an OECD’s attempt in the direction of construing a common notion of abuse. Paragraph 9.5 states ‘It is important to note, however, that **it should not be lightly assumed** that a taxpayer is entering into the type of abusive transactions referred to above. **A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions [emphasis added]**’.

The nature and scope of this guiding principle is quite controversial.

According to Arnold and Van Weeghel, ‘[a]rguably it [the guiding principle of paragraph 9.5] establishes a treaty anti-avoidance rule. At the very least, it introduces an important element of balance.’<sup>7</sup>

Martín Jiménez is of the opinion that paragraph 9.5 expresses the OECD’s position on the notion of treaty abuse<sup>8</sup>. Thus, treaty abuse would occur when: (a) **a main purpose for entering into certain transactions or arrangements [is] to secure a more favourable tax position**, (b) **and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions [emphasis added]**.

According to the qualification given in chapter IV of the present study, the Commentaries to the OECD Model Convention are part of the context of a treaty. Therefore, they are usually expression of the will of the parties at the moment of the conclusion of a treaty<sup>9</sup>. Nevertheless, as emphasized in chapter IV, the fact that the Commentaries are the expression of the common intentions of the parties to a tax treaty needs to be proved case by case since the content and the drift of the OECD Commentaries can be really different<sup>10</sup>. In these specific circumstances, considering that the Commentary to art 1 emphasizes the existence of two different approaches taken by the OECD member countries, it is difficult to maintain that this Commentary is expression of the common

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<sup>7</sup> Arnold, B.J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 93.

<sup>8</sup> Martín Jiménez, A.J., *The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A case for the Declining Effect of the OECD Commentaries ?*, in Bulletin for international fiscal documentation, Vol. 58 (2004) No. 1, p. 19.

<sup>9</sup> See, *infra*, chapter IV.

<sup>10</sup> See, *infra*, chapter IV.



intention of the parties at the moment of the conclusion of a tax treaty based on the OECD Model Convention.

At the same time, it cannot be maintained that through paragraph 9.5 of the Commentary the OECD has elaborated a general anti-abuse clause since this interpretation is in contrast with the approach that allows the member states to apply a domestic notion of abuse on the basis of the assumption that there is no conflict between domestic anti-abuse rules and treaty provisions. If the OECD allows some states to qualify abuse of a treaty on the basis of what is abuse of domestic law and other states to qualify abuse of a treaty on the basis of the interpretation of the treaty itself, it cannot certainly be maintained that the OECD has elaborated a unitary anti-abuse doctrine that member states should follow. On the contrary, the OECD has legitimized two opposite approaches which are based on two opposite conceptions of treaty abuse.

This conclusion leads to a clear consequence. Given the absence of a unitary anti-abuse doctrine, the only interpretative approach that the OECD allows is the evaluation of the relationship between domestic anti-abuse rules and treaty provisions.

Certainly, paragraph 9.5 supports the position according to which domestic anti-abuse provisions cannot be applied without limits. On the contrary, the relevant treaty provisions must be taken into consideration when a case of treaty abuse is to be identified<sup>11</sup>.

According to Arnold and van Weeghel, ‘... some type of limitation on the application of domestic anti-avoidance rules in the context of tax treaties is clearly necessary. A country should not be able to avoid its treaty obligations by taking the position that virtually all transactions are abusive and all of its domestic tax rules are anti-avoidance rules.’<sup>12</sup>

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<sup>11</sup> It is worth noting that the guiding principle of par. 9.5 is implicitly applied by the US courts. See Varma, A. P. and West, P. R., United States, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 838: ‘Although US courts do not explicitly states that they are evaluating claims of treaty benefits in the light of the “object and purpose” of the tax treaty, the cases generally are consistent with the statement in paragraph 9(5) of the OECD model tax convention commentary on art. 1 that “the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.”’

The authors add, on the same page: ‘Moreover it is important to note that the “main purpose” language of the OECD model commentary was specifically rejected by the US Senate in its consideration of proposed treaties with Italy and Slovenia. The Senate placed reservations on those treaties when it approved them in 2000, which were based on concerns about a “main purpose” anti-abuse rule. The Slovenians promptly agreed to the treaty with the reservation but the Italian treaty entered into force only in late 2009, after almost 10 years of consideration by the Italians. The delay reportedly related to concerns over the US Senate reservation.’

<sup>12</sup> Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 96.

IJzerman importantly stated: *'If the parties to the treaty are free to apply their own national anti-avoidance doctrines, this might diminish the value of a treaty, as the consensus therein, often reached by way of a compromise, could be set aside unilaterally.'*<sup>13</sup>

De Broe has defined the OECD statement according to which there is no conflict between domestic anti-abuse rules and treaty provisions as 'incorrect'<sup>14</sup>. According to Arnold and Van Weeghel, the absence of conflict is *'... an oversimplification of the entire spectrum between determination of the facts - for example, the determination of the facts that give rise to a place of effective management of a subsidiary as referred to in Para. 10.1 - on the one hand and a recharacterization of established facts pursuant to the application of an anti-avoidance rule on the other.'*<sup>15</sup>

In my opinion, the problem is that this clear distinction between domestic determination of tax liability and treaty provisions is not practicable. This is firstly because the qualification of a treaty abuse cannot simply concern the determination of the facts that give rise to tax liability. The perfect correspondence alleged by the OECD Commentary between domestic anti-abuse rules and domestic provisions determining the facts that give rise to tax liability is certainly not founded. Arnold and Van Weeghel pointed out *'... Para. 9.2. of the Commentary seems to suggest flatly that anti-avoidance rules are no more than ancillary rules, in order to determine the facts that give rise to a tax liability.'*<sup>16</sup>

Zimmer emphasized that *'there is a difference of principle between establishing the facts on the basis of rules of evidence and deciding whether the legal conditions for declaring tax avoidance are fulfilled.'*<sup>17</sup> <sup>18</sup>

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<sup>13</sup> IJzerman, R. L. H., National Report (Netherlands), in *Form and Substance in Tax Law*, Cahiers de droit fiscal international, Volume LXXXVIIa, 2002 Oslo Congress, Kluwer Law International, 2002, p. 466.

<sup>14</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 387.

<sup>15</sup> Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 91.

<sup>16</sup> See also Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 91.

<sup>17</sup> Zimmer, F., General Report, in *Form and substance in tax law*, Cahiers de droit fiscal international, Vol. LVXXXVIIa, Oslo Conference, Kluwer Law International, 2002, p. 31.

<sup>18</sup> In general about the possible existence of a conflict between domestic anti-abuse rules and treaty provisions, see De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 386 *et seq.*; Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 91 – 92.

The same author wrote: ‘*The core of the issue is that the term “facts” is ambiguous. First it may refer to “real” facts, such as a person’s date of birth, the existence of a certain document, or who said what to whom. But few anti-avoidance rules attach legal consequences to such facts, though it is conceivable, for instance, that the date of sending an acceptance letter may be disregarded under an anti-avoidance rule. The existence of such facts is governed by the rules of evidence, not the rules of tax avoidance.*

*Second, the term “fact” may refer to what may be called “legal facts”, that is, “facts” established by the rules of private law or other non-tax fields of law, for instance, how a contract should be interpreted, whether an exchange of letters amount to a contract, or whether a payment from a company to a shareholder should be considered as a salary, loan dividend or capital gain. Such “facts” are not established by evidence, but by a legal process.*<sup>19</sup>

De Broe specified, by mentioning the French text (*‘dispositions qui déterminent les faits générateurs de l’impôt’*), that anti-abuse rules are meant within the Commentary as ‘rules that determine the taxable event’<sup>20</sup>.

Apart from the vagueness of the reference which makes it extremely hard to understand what the Commentary exactly means by using the expression ‘*determining which facts give rise to a tax liability*’, it is clear that the process to qualify a treaty abuse is extremely more complex and – mostly – it is anyway an *interpretative process*.<sup>21</sup>

Arnold pointed out the distinction between a ‘factual approach’ which aims at recognizing the facts that give rise to tax liability and an ‘interpretative approach’ which denies the application of a tax benefit when a transaction lacks economic or commercial substance. The first is the approach taken into consideration by the OECD: domestic law determines the facts on the basis of which the relevant legislation (both national and conventional) applies.

Under the so-called ‘interpretative approach’, domestic anti-abuse provisions do not characterize or re-characterize the relevant facts. They are interpretative rules under which it is possible to establish when a transaction lacks its substantive economic purpose. In this case, treaty benefits are denied. According to Arnold, the OECD Commentary should have taken into consideration also this second approach<sup>22</sup>.

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<sup>19</sup> Zimmer, F., *Domestic Anti-Avoidance Rules and Tax Treaties – Comment on Brian Arnold’s Article*, in *Bulletin for International Fiscal Documentation*, (2005) Vol. 59, No. 1, p. 25.

<sup>20</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 389.

<sup>21</sup> The expression ‘interpretative process’ is used in a wide sense and does not deal with the distinction between ‘factual approach’ and ‘interpretative approach’.

<sup>22</sup> Arnold, B. J., *Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model*, in *Bulletin For International Fiscal Documentation*, Vol. 58 (2004), No. 6, pp. 251 – 252.

In my opinion, regardless of the approach nationally adopted, when a case of treaty abuse needs to be detected, it is not possible to sharply distinguish between domestic rules and treaty provisions.

In order to establish that the obtained tax advantage is illegitimate, the analysis that leads to qualify an abuse cannot disregard the interpretation of the conventional provisions that are assumed to be avoided or anyway breached.

The OECD Commentary would pretend that everything is solved by stating that national law, on the basis of national sovereignty, determines the facts that give rise to tax liability. But clearly the finding of these facts, even when they are 'legal facts', cannot be sufficient in order to establish whether a case of abuse has occurred. It, indeed, requires an analysis in terms of illegitimacy since the main problem remains to distinguish between legitimate tax saving and illegitimate tax planning. It is, therefore, necessary a parameter of legitimacy that cannot be national law exclusively since national law only concerns taxation but it does not govern the limitation of the tax jurisdiction (non-taxation or limited taxation). Therefore, it is only under treaty provisions, which exactly concern non taxation or limited taxation, that one can establish whether non taxation or limited taxation is legitimate or illegitimate.

This is, after all, confirmed by the so-called guiding principle mentioned in par. 9.5 of the OECD Commentary to art. 1: *'the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.'*

Regardless of the actual nature and scope of this statement, it makes clear that any evaluation concerning treaty abuse structurally involves the interpretation of the relevant treaty provisions and cannot be conducted on a national level exclusively.

This is also clear from paragraph 22.1 of the OECD Commentary on art. 1: *'...to the extent that the application of the rules referred to in paragraph 22 results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes.'*

This means, indeed, that a 'recharacterisation of income' or a 'redetermination of the taxpayer' need to comply with the applicable treaty provisions.

In conclusion, the statement of the OECD Commentary that there is no conflict between domestic anti-avoidance rules and treaty provisions cannot be considered founded. First of all, qualification of abuse cannot only concern the determination of the facts that give rise to tax liability. This is a complex interpretative process that cannot exclude consideration for the relevant tax treaty provisions as parameters of legitimacy which contribute to determine tax liability. This means that the illegitimacy of a certain tax planning needs to be evaluated under treaty provisions since exactly these provisions are demanded to establish when non taxation or reduced taxation is legitimate or not. Therefore,

national anti-abuse rules have necessarily to be applied in accordance with treaty provisions and the position according to which there is a clear separation is not plausible.

Thus, with concern to tax treaty override, it is important to emphasize that notwithstanding the OECD's position based on the absence of conflict between national anti-abuse provisions and double tax conventions, tax treaty override is actually possible every time domestic law is adopted or applied in conflict with treaty provisions.

### 3. Does treaty abuse justify tax treaty override ?

The above conducted analysis concerning the relationship between domestic anti-abuse rules and treaty provisions eventually permits to establish whether a law introduced after the conclusion of a tax treaty to prevent tax avoidance or tax evasion can be considered legitimate and applicable by virtue of its sole purpose, regardless of the fact that it may be in conflict with the existing treaties. Avi-Yonah<sup>23</sup> has supported this position and maintained that the adoption and application of domestic anti-abuse law is admissible even when it realizes a tax treaty override because this is in conformity with the purpose of tax treaties to prevent tax avoidance and tax evasion.

On the contrary, the position expressed by the OECD in its 1989 Report on tax treaty override is clear in the sense that tax treaty override cannot be justified in case of treaty abuse. When the definition of tax treaty override is given, the Report states that overriding legislation *'may take the form of a provision that treaty provisions are to be disregarded in certain circumstances (e.g. in cases of treaty shopping or other forms of abuse)'*<sup>24</sup>.

As already explained, this report was the result of a quick reaction to the cases of tax treaty override realized in the U.S. mostly during the 1980s. This explicates the general character of the mentioned statement.

After this Report, the OECD has not specifically treated the topic anymore. Certainly, the OECD's position needs to be examined in the light of the OECD progressive developments which have concerned the relationship between treaty provisions and domestic anti-abuse rules until the 2003 amendments to the Commentary to art. 1 of the OECD Model Convention.

Exactly the position taken by the OECD within the Commentary to art. 1 leads to exclude the possibility that a tax treaty override can be considered admissible in case of treaty abuse. As widely emphasized in the previous paragraph, the OECD admits the application of domestic anti-abuse provisions only on the

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<sup>23</sup> Avi-Yonah, R. S., *Tax Treaty Overrides: A qualified Defence of U.S. Practice*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 65 – 80.

<sup>24</sup> OECD, *Tax Treaty Override*, OECD 1989, p. 5.

basis of the absence of conflict with the OECD Model Convention. Domestic anti-abuse provisions are applicable to the extent that they do not affect tax treaties and are not addressed by them because they determine the facts that give rise to tax liability.

The purpose to prevent treaty abuse in itself cannot justify tax treaty override. The conclusion of the 1989 Report on tax treaty override cannot be said superseded.

It is, therefore, essential to introduce general and/or specific anti-abuse provisions at the moment of the conclusion of a treaty to guarantee a proper safeguard of the national tax base. This position needs to be maintained notwithstanding in 2003 the OECD has deleted a statement from paragraph 7 of the Commentary to art. 1 according to which the application of domestic anti-abuse provisions should have been specifically established by treaty<sup>25</sup>.

The real problem is that the OECD does not have a clear position exactly because, as emphasized above, it merely distinguishes between those countries that interpret abuse under domestic law and those countries that interpret abuse under treaty provisions. The result is a myriad of different positions taken by the OECD member states. Some of them apply national anti-abuse provisions even when they are in conflict with existing tax treaties, others consider the limitation derived by the conclusion of a previous treaty and evaluate the compliance of anti-abuse rules with existing double tax conventions<sup>26</sup>.

The effect of this situation is inevitably the '*creation of international direct tax distortions*' as a consequence of the application for treaty purposes of different notions of treaty shopping<sup>27</sup>.

#### **4. The Dutch and the Canadian approaches: a concrete example of different notions of abuse applicable for treaty purposes**

A case of divergent notions of abuse deriving from an opposite conception concerning the relationship between domestic anti-abuse legislation and tax treaties can be easily showed when the Dutch and the Canadian case law are compared with reference to a well known treaty shopping structure: the so-

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<sup>25</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 385; Martín Jiménez, A. J., *The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A case for the Declining Effect of the OECD Commentaries?*, in *Bulletin for international fiscal documentation*, Vol. 58 (2004) No. 1, p. 18.

<sup>26</sup> For an exhaustive overview of the different positions taken under national law, see *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010.

<sup>27</sup> Jeffery, R. J., *The Impact of State Sovereignty on Global Trade and International Taxation*, Series on International Taxation (No 23), Kluwer Law International, 1999, p. 172.

called ‘cash box’ structure. This structure may be used by individual shareholders to avoid taxation of dividends. It can be structured in many different ways. Usually, the operating subsidiary distributes dividends to the holding company. The holding company transfers the shares to another holding company which has been incorporated by the same shareholder. The first holding, which has become only a cash box company, is sold, normally, to a bank. In this way, capital gains arise instead of dividends, which is advantageous to the individual shareholder when dividends are taxed at a higher rate than capital gains. This was an ‘effective’ structure in the Netherlands until legislation was changed as from 1997 so that the same tax rate was applied to both capital gains and dividends. The cash box structure is, therefore, no longer used in the Netherlands for these particular purposes. It is however still of relevance in international tax planning structures to lower or mitigate Dutch dividend withholding tax claims. In the context of the present study, the case law of the Dutch Supreme Court is particularly important to show how the different positions that countries have taken with regard to the relationship between domestic anti-abuse rules and treaty provisions can lead to opposite results.

For domestic law purposes the Netherlands applies the so called *fraus legis* doctrine which is based on recharacterization of facts (including legal facts). Taxation is determined according to the resulting recharacterization. The *fraus legis* doctrine has been judicially developed. IJzerman defines it as follows: ‘[i]n Netherlands tax law, there can be said to be action in fraudem legis if a taxpayer avails itself of a structuring, chosen exclusively or predominantly with a view to the desired tax consequences, such that the tax consequences desired by the taxpayer must take effect on the grounds of the interpreted tax law, while at the same time the legal form conflicts with the purpose and intent of the law. The conditions – avoidance motive and conflict with the purpose and intent of the law – are cumulative. If it is in fact reasonable to assume that the taxpayer had a commercial motive of more than secondary importance, *fraus legis* may not be applied. Likewise, *fraus legis* may not be applied if, in law, no acts were taken that conflicted with the purpose and intent of the law.’<sup>28</sup>

The Dutch Supreme Court does however not automatically apply the *fraus legis* doctrine for treaty purposes<sup>29</sup> The court evaluates the results of the domestic recharacterization which has been obtained under the *fraus legis* doctrine in the light of the relevant treaty text and context. Only when the domestic recharacterization can be considered compliant with the relevant international convention this recharacterization can have effects for treaty purposes as well. IJzerman commented: ‘One can conclude that there is only limited scope for the application of the Netherlands *fraus legis* doctrine in treaty situations. A conflict with the

<sup>28</sup> IJzerman, R. L. H., National Report (Netherlands), in *Form and Substance in Tax Law*, Cahiers de droit fiscal international, Volume LXXXVIIa, 2002 Oslo Congress, Kluwer Law International, 2002, p. 454.

<sup>29</sup> Hoge Raad, 15 December 1993, No. 29 296, BNB 1994/259, Hoge Raad, 29 June 1994, No. 28 734, BNB 1994/294 and Hoge Raad, 6 December 2002, No.’s 36 773 and 36 774, BNB 2003/285.



*purpose and intent of provisions in a tax treaty appears to be possible only if this conflict can be established on the basis of the treaty text or the notes of the signatories. Naturally, a treaty may contain specific anti-avoidance provisions. Nevertheless, the scope for applying the general *fraus legis* doctrine in treaty situations appears to be very limited.*<sup>30</sup>

With regard to the ‘cash box’ structure the Hoge Raad did not accept – in the cases the court was called to decide – the recharacterization of capital gains as dividends on the basis of the *fraus legis* doctrine. Accordingly, it denied the abusive nature of the ‘cash box’ structures at issue for the application of the relevant treaties. In a leading case decided in 1993 concerning the 1948 tax treaty between the Netherlands and the United States, the Dutch Supreme Court stated: ‘3.3 Under Article VII<sup>31</sup>, Clause 1, of the Treaty ... dividends paid by a body in one of the states ... to a resident ... of the other state, are taxed in the former state at a rate as referred to in this Article. 3.4 Neither the text of the Treaty nor the notes of the signatories show that they had the joint intention, for the purpose of the application of the aforementioned Article VII, Clause 1, to include in the definition of dividends benefits – such as those at issue here, to which benefits the *fraus legis* doctrine in the national law of the State in which the body referred to in Article VII, Clause 1, is established could be applied. 3.5 No support can be found in the text of the Treaty, or in the notes of the parties that are signatories to the Treaty, for the view submitted by the State Secretary ... that the purpose and intent of the Treaty would be misrepresented if the benefits in question cannot be taxed in the Netherlands.’<sup>32 33</sup>

The Dutch Supreme Court, therefore, on the one hand excluded that the domestic recharacterization as dividends could be considered compliant with the article on ‘Dividends’ within the treaty concluded between the Netherlands and the United States. On the other hand, it excluded that a case of abuse of the relevant treaty had occurred. In particular the Dutch Supreme Court denied that the abusive nature of the ‘cash box’ structure at issue could be inferred from the common intentions of the parties<sup>34</sup>.

It is very interesting to note the coherence of the Dutch Supreme Court case law concerning the application of the *fraus legis* doctrine and the previously

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<sup>30</sup> IJzerman, R. L. H., National Report (Netherlands), in *Form and Substance in Tax Law*, Cahiers de droit fiscal international, Volume LXXXVIIa, 2002 Oslo Congress, Kluwer Law International, 2002, p. 468.

<sup>31</sup> This was the ‘Dividends’ article before the tax treaty between the Netherlands and the United States was amended in 1992.

<sup>32</sup> Hoge Raad, 15 December 1993, No. 29 296, BNB 1994/259, paragraphs 3.3/3.5. The translation is of IJzerman. See IJzerman, R. L. H., National Report (Netherlands), in *Form and Substance in Tax Law*, Cahiers de droit fiscal international, Volume LXXXVIIa, 2002 Oslo Congress, Kluwer Law International, 2002, p. 468.

<sup>33</sup> See also Hoge Raad 15 March 1995, 26 531, BNB 1995/150, paragraph 3.4; Hoge Raad 29 June 1994, No 28 734, BNB 1994/294, paragraphs 3.3 – 3.4.

<sup>34</sup> Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 111 –112.



analyzed<sup>35</sup> case law of the same court which regards the application of notional income. Although the domestic legislation concerning notional income has clearly an anti-avoidance purpose, the analyzed case law did not actually concern cases of abuse. The problem at issue regarded the possibility to apply, under art. 3(2) of the relevant treaties<sup>36</sup>, a fictitious definition introduced after the conclusion of the treaty. Recharacterization was not at issue but the domestic definition was a law-made fiction. The Dutch Supreme Court ruled that the introduction of a legal fiction or lump-sum after the conclusion of a treaty is not admissible when it determines a shift in the allocation of the taxing power as originally established by the parties at the moment of the conclusion of a treaty. The reasoning of the Dutch Supreme Court denying the application of the *fraus legis* doctrine for treaty purposes is exactly the same as the reasoning concerning notional income. The possibility of recharacterizing items of income or capital is not excluded in principle. However, this recharacterization should not cause a shift in the allocation of the taxing power by applying a distributive rule which does not cover the real items of income or capital as resulting from the court's qualification. The Dutch Supreme Court looks for the real nature of the item of income or capital at issue in order to establish which distributive rule is rightly applicable. It can therefore be maintained that the purpose of the Dutch Supreme Court is – also in the case law concerning the application of the *fraus legis* doctrine – to apply the relevant distributive rule as determined on the basis of the very nature of income or capital at issue. The purpose is to avoid that the originally established allocation of taxing power is disrupted. It is also worth noting that when such a shift in the taxing power of the contracting states occurs the Supreme Court mentions the violation of the principle of good faith under the Vienna Convention on the Law of Treaties<sup>37</sup>. All these aspects coherently converge in a position of the Dutch Supreme Court that sees the violation of a treaty as abusive in a wide sense.

Arnold and Van Weeghel pointed out that the case law of the Dutch Supreme Court concerning notional income could be interpreted as allowing the application of the *fraus legis* doctrine for treaty purposes under certain circumstances.<sup>38</sup> They took this position on the basis of the reasoning of the court according to which the introduction of a new fictitious definition which determines a shift in the original allocation of the taxing power can be allowed when the other contracting state had already made the same amendment at the moment the new definition is introduced. As a consequence, the *fraus legis* doctrine could

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<sup>35</sup> This case law has been analyzed in Chapter IV of the present study.

<sup>36</sup> Corresponding to art. 3(2) of the OECD Model Convention.

<sup>37</sup> This is true not only with reference to the case law concerning *fraus legis* and notional income but also with reference to the case law concerning exit taxation which has been examined in chapter IV of the present study.

<sup>38</sup> Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 111 – 114.

be applied for treaty purposes when the resulting recharacterization is accepted also in the other contracting state<sup>39</sup>. On the basis of the same case law a certain recharacterization could be accepted when it was already applied before the conclusion of the relevant treaty<sup>40</sup>.

This position of the Dutch Supreme Court which strongly safeguards treaty obligations is clearly respectful of article 94 of the Dutch Constitution that, as showed in the country analysis conducted in the second chapter of this study, imposes the prevalence of international treaty obligations on domestic law.

Recalling the OECD Commentary to art. 1, the Netherlands is, indeed, one of those countries that do not apply domestic-anti abuse rules when they are in conflict with treaty obligations. The Netherlands has, consequently, expressed the following ‘Observation’ to the mentioned Commentary: ‘27.7 *The Netherlands does not adhere to the statements in the Commentaries that as a general rule domestic anti-avoidance rules and controlled foreign companies provisions do not conflict with the provisions of tax conventions. The compatibility of such rules and provisions with tax treaties is, among other things, dependent on the nature and wording of the specific provision, the wording and purpose of the relevant treaty provision and the relationship between domestic and international law in a country. Since tax conventions are not meant to facilitate the improper use thereof, the application of national rules and provisions may be justified in specific cases of abuse or clearly unintended use. In such situations the application of domestic measures has to respect the principle of proportionality and should not go beyond what is necessary to prevent the abuse or the clearly unintended use.*’

At the opposite is the position of Canada which, instead, applies domestic anti-abuse legislation notwithstanding the existence of conflicts with tax treaties in force. This is explicitly stated within the text of the Canadian ‘General Anti-avoidance Rule’ (GAAR)<sup>41</sup>.

Actually, when the Canadian GAAR was enacted in 1988 there was no specific reference to treaty abuse. In many cases taxpayers used these argument to elude the application of the clause in case of treaty abuse. In 2005 the GAAR has been amended so that ‘ - the definition of “tax benefit” would include any reduction, avoidance or deferral of tax payable under the Income Tax Act or increase in a tax refund

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<sup>39</sup> This would be for example the case in Canada, the United States and New Zealand where national courts apply the recharacterisation of dividends in cases of cash box structures.

<sup>40</sup> These specific aspects of the Dutch Supreme Court case law concerning notional income have been explained and commented in chapter IV of this study.

<sup>41</sup> Goyette, N. and Halvorson, P. D., *Canada*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 175; Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 115. See also Arnold, B. J., *The Long, Slow, Steady Demise of the General Anti-Avoidance Rule*, in *Canadian Tax Journal/ Revue Fiscal Canadienne* (2004), Vol. 52, No. 2, pp. 488 – 511.

as a result of a tax treaty; and - the concept of misuse and abuse would be broadened to include misuse and abuse of tax treaty.”<sup>42</sup> Very importantly, the amendments have had retroactive effect to 1988 (when the GAAR was enacted) so that all the pending cases have been covered by the new anti-abuse clause.

The Government explained that the amendments have been limited to clarify the scope of existing legislation<sup>43</sup>. However, at the same time the Income Tax Conventions Interpretation Act was amended with retroactive effect to 1988. It was clearly established that in case of conflict the GAAR prevails on tax treaties<sup>44</sup>. In fact, it was a general authorization to tax treaty override.

This Canadian position according to which domestic law prevails over treaty provisions is, indeed, reflected in case law. As emphasized at the beginning of this paragraph a case concerning a cash box structure had – in fact – an opposite solution than the solution adopted in the Netherlands by the Supreme Court.

The case is *RMM Canadian Enterprises v. The Queen*<sup>45</sup>. A company resident in the United States (‘EC’) held a Canadian subsidiary ‘EL’ which in turn held another subsidiary ‘ECL’. The Canadian company ‘RMM’ obtained a loan from a U.S. bank and purchased the shares that ‘EC’ owned in ‘EL’. The two subsidiaries (‘EL’ and ‘ECL’) became cash box companies that merged into RMM and whose cash was used by RMM to pay back the bank (only a few days after the purchase of the shares had occurred). This transaction led to the realization of capital gains that – however – the U.S. taxpayer claimed to be exempt under the applicable United States – Canada tax treaty. This claim was denied by the Canadian tax administration that – instead – recharacterized the realized capital gains as dividends for an amount that exceeded the paid-up capital of ‘EL’. Both companies ‘EC’ and ‘RMM’ were assessed for the corresponding withholding tax. The two companies consequently appealed to the Canadian Tax Court, which is the Court of first instance in tax matters. The appeal was, however, dismissed<sup>46</sup>. The Tax Court accepted the recharacterization under the Canadian GAAR and applied art. 10 (concerning dividends) of the tax treaty between Canada and the United States instead of art. 13 (concerning capital gains).

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<sup>42</sup> Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 115.

<sup>43</sup> Goyette, N. and Halvorson, P. D., *Canada*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 175.

<sup>44</sup> Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 116.

<sup>45</sup> *RMM Canadian Enterprises Inc. and Equilease Corporation v. The Queen* [1998] 1 CTC 2300 (TCC).

<sup>46</sup> Innes, W. I., Boyle P. J., Fraser Milner Casgrain (Firm) and Nitikman, J. A., *The Essential GAAR Manual: Policies, Principles and Procedures*, CCH Canadian, 2006, pp. 269 – 270.

The Canadian Tax Court qualified the operation at issue abusive under domestic law and the domestic qualification determined the applicable distributive rule under the relevant tax treaty. The court stated ‘... to permit such a transaction to shelter under the convention would be to sanction an abuse of the treaty. It is true that section 245<sup>47</sup> speaks of a misuse or abuse of the Act, but I can see no reason why a treaty provision should not be subject to the same principles of interpretation as domestic statutes insofar as they require that the provisions be construed in accordance with their object and spirit and the telos at which they are aimed and not in a manner that permits the perpetration of an abuse of the treaty.’<sup>48 49</sup>

## 5. The specific OECD’s position about CFC legislation

The 2003 amendments to the OECD Commentary to art. 1 have clarified the OECD’s position concerning the relationship between domestic controlled foreign company<sup>50</sup> legislation and double taxation conventions. Contrary to the previous version of the Commentary, the OECD’s view is now expressed separately from the position generally concerning the relationship between treaty provisions and domestic anti-abuse rules.

Paragraph 23 of the Commentary to art. 1 states: ‘[i]t is recognised that controlled foreign companies legislation ... is not contrary to the provisions of the Convention’. The sentence expressly refers to the ordinary structure characterizing CFC legislation which ‘result[s] in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities’.

Thus, according to the OECD, there is no conflict between domestic CFC legislation and double taxation conventions. The reason is the same adduced for general anti-abuse provisions. CFC legislation, as well as general anti-abuse provisions, only concern those facts that give rise to tax liability. Specifically, CFC legislation is based on a domestic attribution of income that falls within each contracting state sovereignty. For this reason, CFC rules are not addressed in tax treaties and do not affect them<sup>51 52</sup>. As a consequence, in paragraph 22.1

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<sup>47</sup> It is the Canadian GAAR. It is worth noting that the case was decided before the 2005 amendment.

<sup>48</sup> See Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax law Series, Vol. 2, IBFD Publications BV, 2006, p. 119.

<sup>49</sup> The decision was not appealed.

<sup>50</sup> The designation ‘Controlled foreign corporation’ is also used

<sup>51</sup> See par. 22.1 of the OECD Commentary to art. 1 which recalls the anti-abuse rules mentioned in the previous par. 22, including CFC legislation.

<sup>52</sup> This position was expressed by the OECD already in its 1987 Base Company Report. The words used were substantially identical: ‘The large majority of OECD Member countries consider that rules of this kind [CFC legislation] are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax

of the OECD Commentary to art 1 it is specified: ‘... to the extent that the application of the rules referred to in paragraph 22 [(‘e.g. the use of a base company’)] results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes.’

This OECD position is certainly not uncontested. Belgium, for example, has expressed an ‘Observation’ on the Commentary to art. 1 based on the violation of articles 5(7), 7(1) and 10(5) of the OECD Model Convention<sup>53</sup>. In fact, the position about the relationship between CFC legislation and tax treaty provisions, exactly as with general anti-abuse clauses, is not shared among the OECD member states. Also in this case, there is a minority according to which CFC legislation does not comply with the OECD Model Convention<sup>54</sup>.

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*treaties and are therefore not affected by them.’ (par. 39). It is worth noting that in the previous paragraph the OECD had already clarified that contracting states could attribute to taxpayers income of the base company (par. 38). See OECD, *Double Taxation Convention and the Use of Base Companies*, OECD 1987.*

<sup>53</sup> According to par. 27.4 of the OECD Commentary to art. 1, ‘Belgium cannot share the views expressed in paragraph 23 of the Commentary. Belgium considers that the application of controlled foreign companies legislation is contrary to the provisions of paragraph 7 of Article 5, paragraph 1 of Article 7 and paragraph 5 of Article 10 of the Convention. This is especially the case where a Contracting State taxes one of its residents on income derived by a foreign entity by using a fiction attributing to that resident, in proportion to his participation in the capital of the foreign entity, the income derived by that entity. By doing so, that State increases the tax base of its resident by including in it income which has not been derived by that resident but by a foreign entity which is not taxable in that State in accordance with the Convention. That Contracting State thus disregards the legal personality of the foreign entity and therefore acts contrary to the Convention (see also paragraph 79 of the Commentary on Article 7 and paragraph 68.1 of the Commentary on Article 10).’

<sup>54</sup> It is interesting to report, in addition to the observation expressed by Belgium, the other observations on the Commentary to art. 1 expressed by some OECD member states to the OECD’s position about the compatibility between CFC legislation and tax treaties. Each of these observations highlights different aspects of the problem:

‘27.5 Concerning potential conflicts between anti-abuse provisions (including controlled foreign company - CFC - provisions) in domestic law and the provisions of tax treaties, Ireland considers that it is not possible to have a simple general conclusion that no conflict will exist or that any conflict must be resolved in favour of the domestic law. This will depend on the nature of the domestic law provision and also on the legal and constitutional relationship in individual member countries between domestic law and international agreements and law. Also, Ireland does not agree with the deletion of the language in paragraph 26 (as it read until 2002), which stated: “It would be contrary to the general principles underlying the Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be suspected”.

27.6 Luxembourg does not share the interpretation in paragraphs 9.2, 22.1 and 23 which provide that there is generally no conflict between anti-abuse provisions of the domestic law of a Contracting

The provisions on the basis of which the conflict of CFC legislation with the OECD Model Convention is mainly argued are articles 7(1) and 10(5).

Accordingly, these articles are mentioned by the OECD Commentary to art. 1 in paragraph 23 where any conflict with CFC legislation is clearly excluded: *‘It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that ... controlled foreign companies legislation conflicted with these provisions. For the reasons explained in paragraphs 13<sup>55</sup> of the Commentary on Article 7 and 37 of the Commentary on Article 10, that interpretation does not accord with the text of the provisions. It also does not hold when these provisions are read in their context.’*

Art. 7(1) of the OECD Model Convention states that *‘[p]rofits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.’*

This is one of the fundamental rules on which the entire functioning of the OECD Model Convention is based. A corporation is considered a separate entity in respect to its shareholders. As a consequence, according to art. 7(1), profits of a corporation can be taxed only in its country of residence unless the corporation has a permanent establishment in the other contracting state.

However, according to the OECD, art. 7(1) does not affect the right of a contracting state to attribute the undistributed profits of a corporation to its

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*State and the provisions of its tax conventions. Absent an express provision in the Convention, Luxembourg therefore believes that a State can only apply its domestic anti-abuse provisions in specific cases after recourse to the mutual agreement procedure.*

*27.7 The Netherlands does not adhere to the statements in the Commentaries that as a general rule domestic anti-avoidance rules and controlled foreign companies provisions do not conflict with the provisions of tax conventions. The compatibility of such rules and provisions with tax treaties is, among other things, dependent on the nature and wording of the specific provision, the wording and purpose of the relevant treaty provision and the relationship between domestic and international law in a country. Since tax conventions are not meant to facilitate the improper use thereof, the application of national rules and provisions may be justified in specific cases of abuse or clearly unintended use. In such situations the application of domestic measures has to respect the principle of proportionality and should not go beyond what is necessary to prevent the abuse or the clearly unintended use.*

*27.9 Switzerland does not share the view expressed in paragraph 7 according to which the purpose of double taxation conventions is to prevent tax avoidance and evasion. Also, this view seems to contradict the footnote to the Title of the Model Tax Convention. With respect to paragraph 22.1, Switzerland believes that domestic tax rules on abuse of tax conventions must conform to the general provisions of tax conventions, especially where the convention itself includes provisions intended to prevent its abuse. With respect to paragraph 23, Switzerland considers that controlled foreign corporation legislation may, depending on the relevant concept, be contrary to the spirit of Article 7.’*

<sup>55</sup> Paragraph 23 of the 2010 Commentary to art. 1 actually refers to par. 14 of the Commentary to art. 7. The reference is clearly to be intended to paragraph 13.

resident taxpayers who are shareholders of that corporation. It is argued that tax treaties do not address the rights of each contracting states ‘to determine what it considers to be the facts giving rise to tax liability (“taxable event”); what is the amount of taxable income (“taxable object”); who is the taxpayer (“taxable subject”); if and to what extent activities and/or income of a taxpayer can be attributed to another taxpayer and when the tax liability arises.’<sup>56</sup>

Thus, paragraph 13 of the Commentary to art. 7, which is recalled in paragraph 23 of the Commentary to art. 1, states: ‘*The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents’ participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10).*’ Exactly because each contracting state has the sovereign power to individuate who is a resident taxpayer within its own country, what is taxable income and, consequently, to attribute this income to its own residents, CFC legislation only concretizes the rights of each contracting state, independently of the fact that the same income is possibly taxed in the CFC’s state because tax treaties do not cover cases of economic double taxation<sup>57</sup>.

On the basis of the same reasoning, the OECD excludes that CFC legislation conflicts with art. 10(5) of the OECD Model Convention.

As already stated, paragraph 23 of the OECD Commentary to art. 1 mentions paragraph 37 of the Commentary to art. 10. In turn, paragraph 37 states: ‘*[i]t might be argued that where the taxpayer’s country of residence, pursuant to its controlled foreign companies legislation or other rules with similar effect seeks to tax profits which have not been distributed, it is acting contrary to the provisions of paragraph 5. However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.*’

Again, CFC legislation does not affect tax treaties. In this specific case, it is argued that art. 10(5) of the OECD Model Convention only concerns the case in which the state of source wants to tax undistributed profits of a corporation situated in the state of residence. In any case, it is further specified, the provision

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<sup>56</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 576.

<sup>57</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, pp. 576 -582.



does not deal with the taxation of shareholders but only with taxation of the corporations.

Very importantly, the OECD concludes in paragraph 23 of the Commentary to art. 1 that states do not need to expressly confirm the compliance of CFC legislation with tax treaties based on the OECD Model Convention.

This statement does not actually reflect the fact that, as already emphasized above, the OECD member states are divided<sup>58</sup> about the relationship between CFC legislation and double tax conventions. Each OECD member country follows its own approach according to its national legal system. And although it can be stated that the majority of them, in general terms, apply CFC legislation, there is a sharp opposition between those OECD countries that apply a CFC regime and those that have adopted tax favourable regimes to attract investments.

Accordingly, De Broe points out: ‘... no unanimity has been reached within the OECD. This is not surprising. Several OECD Member Countries have enacted special types of favourable tax legislation designed to attract foreign investment (e.g. measures to attract financial centres or holding companies (e.g. Belgium; Ireland; Luxembourg; the Netherlands) and others have favourable tax legislation for corporate taxpayers generally (e.g. Cyprus; Ireland; Switzerland)).’<sup>59</sup>

Aigner, Scheuerle and Stefaner, in their General Report commenting different national CFC regulations, highlight that even among the OECD member countries that adopt CFC legislation different positions are strongly supported: ‘[t]he reports show that the distributive rules relevant to CFC legislation are disputed heavily. Some want to apply Art. 7 OECD-MC as a consequence of the reference to domestic law according to Art. 3 (2) OECD-MC. If the income is characterized as business profits according to domestic law, they want to apply the distributive rule for business profits. According to this view, randomly chosen techniques in the domestic law determine the compatibility of CFC legislation with tax treaties. If a look-through approach is chosen, the application of Art. 7 OECD-MC seems reasonable according to this view. If the CFC legislation is designed to distribute fictitious dividends, the application of Art. 10 OECD-MC seems reasonable. However, the scope of the respective distributive rule has to be examined in detail.

It is also stated that Art. 3 (2) does not allow a reference to domestic law if an interpretation may be derived from the context of the convention by applying all means of interpretation.’<sup>60</sup>

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<sup>58</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, pp. 575–576.

<sup>59</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 584.

<sup>60</sup> Aigner, J., Scheuerle, U. and Stefaner, M., General Report, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 33–34.



The OECD itself in paragraph 23 of the Commentary to art. 1 states that ‘*the design of this type of legislation varies considerably among countries*’.

This variety (and sometimes conflict) of positions appears clear from the case law which will be examined in the following paragraphs<sup>61</sup>. Four important judgments from four countries with different constitutional systems show that the OECD position is clearly not followed by all OECD member countries and cannot, therefore, be considered expression of a clear will of the contracting parties at the moment of the conclusion of a tax treaty. At least two of these cases realized a tax treaty override.

## **6. The UK attribution of notional income on the basis of fictitious residence: which consequences for the applicable tax treaties?**

CFC legislation was introduced relatively late<sup>62</sup> in the United Kingdom. Many factors influenced the non adoption of such a regime for a long time. Mainly it depended on the central role that the concept of tax residence has always had in the UK.

Traditionally, British tax jurisdiction is founded on the principle expressed by Lord Herschell in *Colquhoun v. Brooks*: ‘[t]he Income Tax Acts ... impose a territorial limit, either that from which the taxable income is derived must be situated in the United Kingdom or the person whose income is to be taxed must be resident there.’<sup>63</sup>

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<sup>61</sup> The case law about CFC legislation and tax treaty override is very limited. The commented judgments have been chosen on the basis of the general opinion in literature about their particular significance with regard to tax treaty override. See, *ex multis*, Bader, R. G., *CFC Legislation in the European Union and the Alternative CSC Concept*, (thesis defended at Tilburg University), 2012, pp. 329 *et seq.*; IFA, *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, Volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010; De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, pp. 594 *et seq.*, pp. 454 – 458.

<sup>62</sup> The UK CFC legislation was introduced with the Finance Act 1984. CFC legislation was introduced for the very first time by the United States in 1937. Germany followed in 1972.

For a general analysis of CFC legislation in the UK, see Ullah, M., *National Report United Kingdom*, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 605 – 638. For an update about the recent amendments to the UK CFC legislation it is possible to consult the website of the HM Treasury directly at [http://www.hm-treasury.gov.uk/controlled\\_foreign\\_companies.htm](http://www.hm-treasury.gov.uk/controlled_foreign_companies.htm).

<sup>63</sup> *Colquhoun v. Brooks* (1889) 2 TC 490. See also Ullah, M., *National Report United Kingdom*, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, p. 607.

This approach, in combination with the application of the incorporation principle, facilitated the allocation of company residence in tax havens. Thus, in order to curb tax avoidance and evasion, the UK case law has developed a wide concept of place of central management and control<sup>64</sup>. In addition, the transfer of a company is subordinated to the HM Treasury consent<sup>65</sup>.

Nevertheless, the abolition of the exchange controls in 1979 determined an increasing flow of income to subsidiaries allocated in tax havens or low tax countries. As a consequence, in 1981 the then Inland Revenue<sup>66</sup> proposed the introduction of a CFC regime.

International treaties are not automatically applicable within the United Kingdom's legal system. After its conclusion a treaty needs to be incorporated by the Parliament into national law to become effective within the UK legal system<sup>67</sup>.

As follows from what has been explained in the second chapter, this system has directly effect on the relationship between treaty provisions and domestic law. In fact, the United Kingdom is one of those countries that admit treaty override since the incorporating statute is applied instead of the tax treaty and it can be modified through a subsequent statute. Accordingly, the UK is one of those OECD member states that apply domestic anti-abuse provisions regardless of treaty provisions and, therefore, even in case of a conflict.

Emblematic the following passage: *'Double tax conventions ... may well stand in conflict with UK domestic anti-avoidance provisions, including in ways which have not yet been fully tested before the courts. This conflict may be countered through further domestic provisions intended to re-establish the domestic law position, **some involving a more overt treaty override than others [emphasis added]**. (Very occasionally, however, the DTC will itself contain an anti-avoidance provision which would not otherwise be reflected in UK domestic law and the domestic law provides that no better result may be obtained.)*

*Judicial approaches to tax avoidance have been more restrained in construing DTCs than in construing domestic legislation, given in part the need for uniform construction of*

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<sup>64</sup> Panayi, C. H. J. I., *United Kingdom*, in Maisto, G. (editor), *Residence of Companies under Tax Treaties and EC Law*, EC and International Tax Law Series, Vol. 5, IBFD, 2009, pp. 826 – 835; Ullah, M., *National Report United Kingdom*, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 607 – 608.

<sup>65</sup> Although its scope was limited with the Income and Corporation Taxes Act 1988, after the notorious decision of the Court of Justice of the European Union in the case *The Queen v Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust PLC*.

<sup>66</sup> On the 18<sup>th</sup> of April 2005 the Inland Revenue merged with the Her Majesty's Customs and Excise department and the Her Majesty's Revenue & Customs (HMRC) department was created.

<sup>67</sup> Vogel, K., *The Domestic Law Perspective*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 4.

*DTCs. This has further fuelled the difficult relationship between domestic anti-avoidance provisions and DTCs.*

***The statement at paragraph 22(1) of the OECD commentary on article 1, to the effect that there will be no conflict between anti-avoidance provisions and DTCs, is therefore too bald a statement as far as UK law and practice is concerned [emphasis added].***<sup>68</sup>

This analysis is definitively confirmed by the judgment issued in *Bricom Holding Ltd v. IRC*<sup>69 70</sup>, concerning the relationship between the UK CFC legislation and a tax treaty concluded between the United Kingdom and the Netherlands. CFC legislation has been considered prevailing on the applicable tax treaty on the basis of the sole interpretation of national law. This judgment has, in fact, authorized a tax treaty override in the UK since CFC legislation has been adopted after the conclusion of the relevant tax treaty.

Interestingly, the Court of Appeal that issued the judgment explicitly refers to the necessity of incorporating international agreements in the UK legal system to make them effective and, therefore, it checked the exact incorporation of the relevant double tax agreement.

Bricom Holding Limited ('Bricom') is incorporated and resident for tax purposes in the UK. It is a subsidiary indirectly owned by 'The Bricom Group Limited' ('BGL'). Spinneys International BV ('Spinneys') is incorporated and resident for tax purposes in the Netherlands. It is a directly owned subsidiary of Bricom. Consequently to a loan, BGL was paying interests to Spinneys. According to art. 11 of the relevant tax treaty, these interests were subjected to tax in the Netherlands and exempted in the UK.

Spinneys is considered a controlled foreign corporation under UK legislation. As a consequence, Bricom, which is the only Spinneys' shareholder, is liable to tax in the United Kingdom.

<sup>68</sup> Morton, P. and Sykes, L., United Kingdom, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 805.

<sup>69</sup> *Bricom Holding Ltd v. IRC*, [1996] STC (SCD) 228, appeal dismissed [1997] STC 1179 (CA). The present analysis exclusively concerns the decision on appeal.

<sup>70</sup> Bader, R. G., *CFC Legislation in the European Union and the Alternative CSC Concept*, (thesis defended at Tilburg University), 2012, pp. 342 – 345; Morton, P. and Sykes, L., United Kingdom, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, pp. 810 – 812; De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, pp. 595 – 598; Ullah, M., National Report United Kingdom, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 625 – 631; Sandler, D., *Tax Treaties and Controlled Foreign Company Legislation*, in *British Tax Review*, (1998) No. 1, pp. 52 – 61; Sandler, D., *Tax Treaties and Controlled Foreign Company Legislation – Pushing the Boundaries*, Kluwer Law International, 2<sup>nd</sup> edition, 1998, pp. 202 *et seq.*

Bricom does not contest Spinneys' qualification as a controlled foreign corporation but it claims its right to obtain an exemption for the interests paid in the Netherlands.

The Court of Appeal recognizes that under art. 11 of the applicable tax treaty the interests paid to Spinneys should be exempted in the UK. Furthermore, art. 2(1) of the treaty extends its scope to *'identical or substantially similar taxes which are imposed by either State after the date of signature of this convention in addition to, or in place of, the existing taxes.'*

However – as the Court of Appeal specifies – the relevant tax treaty can be considered applicable only by virtue of a domestic Act. Specifically, tax treaties are only effective by virtue of Section XVIII of the Income and Corporation Taxes Act 1988. Its Section 788(3) establishes: *'[s]ubject to the provisions of this Part, the arrangements shall, notwithstanding anything in any enactment, have effect in relation to income tax and corporation tax in so far as they provide – (a) for relief from income tax, or from corporation tax in respect of income or chargeable gain ...'*

It is, therefore, domestic legislation that establishes the applicability and determines the scope of international agreements. Section 788(3) expressly allows relief from income tax *'notwithstanding anything in any enactment'*. This provision is, however, *'subject to the provisions'* of Section XVIII of the Income and Corporation Taxes Act 1988. And this Section, as emphasized by the Court of Appeal, does not include *'identical or substantially similar taxes'*, which are consequently excluded from those provisions on which double taxation agreements prevail. In this case the UK is not obliged to guarantee a relief from income tax.

The CFC legislation at issue is regulated by Sections 747(1) and (2) of the Income and Corporation Taxes Act 1988: *'Imputation of chargeable profits and creditable tax of controlled foreign companies (1) If the Board have reason to believe that in any accounting period a company – (a) is resident outside the United Kingdom, and (b) is controlled by persons resident in the United Kingdom, and (c) is subject to a lower level of taxation in the territory in which it is resident, and the Board so direct, the provisions of this Chapter shall apply in relation to that accounting period. (2) A company which falls within paragraphs (a) to (c) of subsection (1) above is in this Chapter referred to as a "controlled foreign company"'*.

Being this the case *'a sum equal to corporation tax at the appropriate rate'* is chargeable on the shareholders resident in the UK (Section 747(a)) in proportion to their participation in the foreign company (Section 747(3)). The taxable sum is a notional one since taxation is based on the assumption that the foreign company is resident in the UK. According to Section 747(6)(a) *'[i]n relation to a company resident outside the United Kingdom – (a) any reference in this Chapter to its chargeable profits for an accounting period is a reference to the amount which, on the assumptions in Schedule 24, would be the amount of the total profits of the company for that period on which, after allowing for any deductions available against those profits, corporation tax would be chargeable; ...'* In turn, par. 1(1) of Schedule 24 specifies that *'[t]he company shall be assumed to be resident in the United Kingdom'*.

In essence, Spinneys' profits are calculated as if it were a company resident in the UK and its profits, so calculated according to UK rules, are apportioned to its shareholders resident in the UK. In this case Bricom is its sole shareholder and consequently it is taxed on the entire chargeable amount.

Bricom does not contest the fictitious residency of Spinneys in the UK. However, it argues that par. 1(1) of Schedule 24 does not expressly exclude a case of double taxation. Thus, Bricom maintains that Spinneys should be considered not only fictitiously resident in the UK, but, in correspondence with the reality, also resident in the Netherlands. Accordingly, the relevant tax treaty should apply and the interests taxed in the Netherlands should be excluded from the amount of profits as calculated under UK law.

The Court of Appeal dismisses Bricom's argument and interprets par. 1(1) of Schedule 24 so that it establishes the residence in the UK in alternative to the residence in the Netherlands and not in addition to it. The Court adds a passage where it explains its position about the interpretation and application of fictions. This is extremely important for our purposes considering that fictions – and the way they are interpreted – have an essential role in individuating cases of tax treaty override.

Also in this case the application of a fictitious residency provision becomes essential for the conclusion of the case. '*... The scope of a deeming provision is a question of construction and is not subject to any special rule. As on any other question of statutory construction, the Court must attempt to ascertain the intention of Parliament from the words used in the light of the legislative purpose. A statutory hypothesis, no doubt, must not be carried further than the legislative purpose requires, but the extent to which it must be carried depends upon ascertaining what the purpose is*'.

It is, therefore, essential for this decision the fact that, according to the Court, par. 1(1) of Schedule 24 introduces an assumption according to which Spinneys is deemed to be resident in the UK, although this does not correspond to reality. If taxation had been based on reality, the UK could never have had the right to tax a company resident in another state. Nevertheless, UK CFC legislation applies on the basis of a fiction and this fiction allows UK taxation.

It is worth noting that the Court does not give value to the fiction for its purpose, i.e. to curb tax avoidance. In fact, no limits (for example the possibility to rebut it) to the application of the deeming provision are recognized but the intention of the legislator. The parliamentary will underlying the UK CFC legislation is to tax a controlled foreign corporation as if it were a company resident in the UK. The relative amount is, therefore, not real but notional.

Accordingly, the interests at issue must be included in the calculation of the profits chargeable in the UK without any exemption. The Court of Appeal states literally: '*The chargeable profits referred to in Section 747(4)(a) must be ascertained without reference to the Double Taxation Agreement ...*'. The reason is exactly that the chargeable amount has a notional nature. It is the mere result of a calculation within which interests lose their proper specific characterization and are simply part of that calculated amount. The chargeable amount '*... merely provides a*

*measure by which an element in a conventional or notional sum is calculated, and it is that conventional or notional sum which is apportioned to the taxpayer and on which tax is charged.'*

This all is possible on the basis of the fact that a foreign company is deemed to be resident in the UK and only in the UK.

The most relevant aspect for our purposes – the aspect of this decision which has been mostly criticized<sup>71</sup> – is certainly the fact that the Court's reasoning is entirely based on a strict interpretation of domestic law.

In accordance with the principle under which the applicability of international treaties is subordinated to its incorporation into domestic law, it is only domestic law that determines the scope of an international agreement.

The Court of Appeal excluded the applicability of art. 11 of the convention between the United Kingdom and the Netherlands on the basis of a statutory fiction. Being satisfied the CFC qualification conditions, a company resident for tax purposes abroad is deemed to be resident in the UK. As a consequence, it is taxed on a notional amount computed on the basis of the British corporation tax rules. This statutory deeming provision has the legal force to exclude the application of a double taxation convention by substituting the Dutch residence with the British residence.

In this regard, it is also important to point out that Bricom's defence was only based on the breach of art. 11 of the relevant tax treaty. The Court was, therefore, not called to verify the compliance of the UK CFC legislation with articles 7(1) and 10(7)<sup>72</sup> of the tax treaty concluded between the United Kingdom and the Netherlands.

However, it is clear that the fictitious residence would have prevailed regardless of the specifically invoked treaty provisions. Highly probably the decision would have been based on the same interpretative reasoning.

Sandler also emphasizes that, given the position of the Court about the notional character of the applicable charge, it is unlikely that it would have applied the tax treaty any way and considered UK CFC legislation in breach of articles 7(1)

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<sup>71</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 597; Ullah, M., National Report United Kingdom, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, p. 629: 'Whilst the reasoning for the decision is based on the supremacy of U.K. domestic law (ie a treaty can only have effect to the extent that it is enabled by domestic law), which may have hampered the approach of the courts, it is clear that Millet L.J. (who gave the only reasoned judgment) had little interest in giving any wider consideration to the issues. **Indeed, the Bricom case is surprising for the very limited discussion of the relevant treaty provisions despite the obvious significance of those provisions to the case [emphasis added]**. Millet L.J. focused primarily on the domestic law. In adopting this narrow approach, his Lordship did not consider the potential relevance of the Vienna Convention on the Law of Treaties 1969.'

<sup>72</sup> It corresponds to art.10(5) of the OECD Model Convention.



or 10(7). Sandler's argument is founded on the following passage of the Court: 'chargeable profits' as defined by section 747(6)(a) are a purely notional sum. They do not represent any profits of Spinneys on which United Kingdom corporation tax is chargeable, for there are no such profits. Nor do they represent any actual payments or receipts of Spinneys, whether of interest or anything else. They are merely the product of a mathematical calculation made on a hypothetical basis and making counterfactual assumptions. The 'chargeable profits' which are defined by section 747(6)(a) exist only as a measure of imputation. What is apportioned to the taxpayer company and subjected to tax is not Spinneys' actual profits but a notional sum which is the product of an artificial calculation'.

However, according to Sandler, a literal interpretation of section 747(6) does not allow this position. He argues: 'Contrary to the court's conclusion, "chargeable profits" are not a "purely notional sum". The purpose and effect of section 747(6) and Schedule 24 is that the "chargeable profits" of a CFC are, in fact, the profits of the CFC (excluding chargeable gains) calculated in accordance with United Kingdom tax laws. This amount is no more a notional amount than the profits of a United Kingdom corporation computed in accordance with the provisions of Taxes Act 1988. The only distinction of consequence between the charging provision in section 747(4)(a) and that in section 6 is the person or persons subject to tax in respect of the CFC's profits.'

Thus, Sandler concludes: '... the calculation of chargeable profits under the CFC legislation is a calculation of the "profits" of the CFC. **The attribution of such profits to a United Kingdom corporation violates certain fundamental principles of tax treaties: that each corporation is treated as a separate taxable entity, and that the profits of a corporation resident in one treaty country are not subject to tax in the other treaty country in the absence of a permanent establishment. By adopting what is, in effect, a consolidation of corporate profits, the CFC legislation contradicts the basic structure of tax treaties [emphasis added].**'

Thus, according to Sandler art. 7(1) should have prohibited the application of the British CFC legislation. This is because Spinneys' profits are in fact charged, although computed according to UK rules on the basis of the assumption that Spinneys is a British company. The applicable charge is not a notional one, but exactly a corporate tax computed according to British corporate tax legislation. In the absence of a permanent establishment, the UK was not allowed to tax Spinneys' profits under art. 7(1).

At the same time, from Sandler's point of view, art. 10(7) could have been applied since in the case at issue the country applying the CFC legislation is also the source country. 'The precondition for the application of Article 10(7) was met because Spinneys, a company resident in the Netherlands, derived income from the United Kingdom. Therefore, Article 10(7) prohibits the United Kingdom from charging a tax on the undistributed profits of Spinneys even if the undistributed profits consist wholly or mainly of income arising in the United Kingdom.'<sup>73</sup>

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<sup>73</sup> Sandler, D., *Tax Treaties and Controlled Foreign Company Legislation*, in *British Tax Review*, (1998) No. 1, p. 57.

De Broe is also of the opinion that, in fact, Spinneys was taxed on business profits computed according to the British corporate tax legislation and that, therefore, the relevant charge could not be considered a notional sum<sup>74</sup>. Accordingly, ‘... it is ... particularly unfortunate that the taxpayer chose to base its arguments on Art. 11 of the treaty ... and not on Art. 7(1) or on Art. 10(7) of the United Kingdom – Netherlands treaty, as the conditions to apply the latter provision were *prima facie* satisfied’<sup>75</sup>

As explained by Morton and Sykes, ‘[w]hat was sought to be taxed on the UK resident parent was not the interest itself but the full profits of the subsidiary. These were computed on a basis which had the result that the interest ceased to be recognizable in what was taxed by the UK. This leaves open the possibility that, had it been possible to do so, reliance on the business profits article of the DTC may have proved more successful.’<sup>76</sup>

The same authors conclude their comment on the Bricom case by emphasizing: ‘[n]evertheless, what Millet JL may well have touched on in the Bricom case is a principle of treaty rather than pure domestic law, to the effect that a contracting state may not circumvent its obligations by attributing the protected income or gains to a resident of that contracting state (reflected in for instance the French CFC decision of *Re Société Schneider Electric*).’<sup>77</sup>

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<sup>74</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 598.

<sup>75</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 597.

<sup>76</sup> Morton, P. and Sykes, L., United Kingdom, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 811, footnote n. 24.

<sup>77</sup> Morton, P. and Sykes, L., United Kingdom, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 812.



## 7. The French Conseil d'Etat does not accept CFC legislation which is not compliant with treaty obligations

The position of the French Conseil d'Etat<sup>78 79</sup> in a case in which it had to establish whether the French CFC legislation<sup>80</sup>, as regulated by art. 209 B of the code général des impôts, was compliant with a tax treaty entered into by France and Switzerland was completely at the opposite in respect to the UK Court of Appeal in the Bricom case.

These were the facts. Schneider was a company resident in France that had a 100% participation in Paramer, a company resident in Switzerland where a more favourable tax regime was guaranteed. The case concerned the possibility that Paramer's profits were attributed to Schneider and taxed in France under art. 209 B of the code général des impôts.

In France the relationship between international and national law is governed by the Constitution and is founded on a conception that – in contrast with the British regime – sees international law prevailing over national law<sup>81</sup>.

<sup>78</sup> Conseil d'Etat, Assemblée, du 28 juin 2002, 232276, Ministre de l'économie, des finances et de l'industrie / Société Schneider Electric, in [www.legifrance.gouv.fr](http://www.legifrance.gouv.fr). See also *Re Société Schneider Electric- appeal no. 232 276*, in International Tax Law Reports, Vol. 4 (2002), No. 6, pp. 1077-1130 (with note of Philip Baker).

<sup>79</sup> Bader, R. G., *CFC Legislation in the European Union and the Alternative CSC Concept*, (thesis defended at Tilburg University), 2012, pp. 334 – 341; Austray, S. – Collet, M., France, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, pp. 322 – 323; De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, pp. 598 – 603; Kabbaj, H. and Raingeard de la Bletière, E., National Report France, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 242 – 244; Gutmann, D., Danon, J. R. and Salome H., *French – Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law*, in Intertax (2003) Vol. 31, No. 4, pp. 156 – 162; Bourtourault, P. Y. and Mbwa-Mboma, M., *French High Tax Court Confirms that the Former France-Switzerland Tax Treaty Overrides the French CFC Legislation*, in Intertax (2002) Vol. 30, No 12, pp. 493 – 498; Vogel, K., *France's Conseil D'Etat: Tax Treaties Prevail Over CFC Rules*, in Bulletin for International Taxation, Vol. 56 (2002), No. 10 (Tax Treaty Monitor: Tax Treaty News), pp. 498 – 499.

<sup>80</sup> Kabbaj, H. and Raingeard de la Bletière, E., National Report France, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 221 – 254. It is worth noting that in 2005 art. 209 B of the French code général des impôts was amended and it was clarified that it concerns a deemed distribution of dividends (see below in this paragraph).

<sup>81</sup> It is also important to recall that France has not signed the Vienna Convention on the Law of Treaties. See [http://treaties.un.org/pages/ViewDetailsIII.aspx?&src=TREATY&mtdsg\\_no=XXIII~1&chapter=23&Temp=mtdsg3&lang=](http://treaties.un.org/pages/ViewDetailsIII.aspx?&src=TREATY&mtdsg_no=XXIII~1&chapter=23&Temp=mtdsg3&lang=)

Thus, in the premise of the judgment it is immediately recalled art. 55 of the French Constitution according to which ‘*Treaties or agreements duly ratified or approved shall, upon publication, prevail over Acts of Parliament, subject, with respect to each agreement or treaty, to its application by the other party*’.<sup>82</sup>

This is, in fact, the starting point of the Conseil d’Etat which preliminarily defines its interpretative approach<sup>83</sup>, given the premise that in France international treaties prevail over national law. Therefore, the court points out that, first of all, it needs to interpret the CFC legislation at issue and establish whether the contested imposition has been validly established from a national point of view, mostly on the basis of a correct income qualification. After that the judge needs to verify whether the relevant international agreement does not prevent the application of the national law as interpreted. This is the ‘subsidiarity principle’ which in France underlies the relationship between national and international law and that found in the judgment at issue an important reaffirmation<sup>84</sup>.

Austry and Collet explains: ‘[t]o determine the principle and rules of taxation in France of some cross-border income, one must first address the domestic treatment irrespective of the tax treaty: this principle of priority of domestic law is also referred to as the “subsidiarity principle”. More precisely, analysis must first be performed under French domestic law in order to determine whether the tax should be levied and under which classification. It is only then and only if the domestic law leads to French taxation that the treaty provisions

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en. See also Gutmann, D., *Tax Treaty Interpretation in France*, in Lang, M. (editor), *Tax Treaty Interpretation*, EUCOTAX Series on European Taxation, Volume 3, Kluwer Law International, 2001, p. 107: ‘*The VCLT is not binding in France because of the reluctance to admit the existence of a jus cogens, a central notion of the Convention. This explains why France was the only State to vote against the Convention when it was adopted [emphasis added]. Nevertheless, the principles contained in the VCLT are considered customary rules that were never criticised as such by France. In particular, France explicitly appealed against the articles of the VCLT regarding interpretation of the treaties when involved in arbitration procedures on the ground that those rules were a mere codification of pre-existing customary rules. To conclude, it may be said that the VCLT principles of interpretation are applicable within the French system even if they are formally deprived of legal efficiency.*’ See also Kabbaj, H. and Raingeard de la Bletière, E., *National Report France*, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, p. 243.

<sup>82</sup> This is the official English translation reported at [www.assemblee-nationale.fr/english](http://www.assemblee-nationale.fr/english). The original French version of art. 55 is ‘*Les traités ou accords régulièrement ratifiés ou approuvés ont, dès leur publication, une autorité supérieure à celle des lois, sous réserve, pour chaque accord ou traité, de son application par l’autre partie*’.

<sup>83</sup> ‘More precisely, it may be said that the *Schneider* case lays down a genuine methodology for the judge’. See Gutmann, D., Danon, J. R. and Salome H., *French – Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law*, in *Intertax* (2003) Vol. 31, No. 4, p. 157.

<sup>84</sup> Austry, S. and Collet, M., *France*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 321.

*will be applied in order to determine whether the right to tax the income is ultimately attributed to France.’<sup>85</sup>*

In the case at issue, France, exactly like the United Kingdom, applies a CFC regime based on an entity method which involves the attribution of the controlled foreign company’s profits to the French shareholder.

Article 209 B of the code général des impôts – in its version applicable at the time of the judgment – stated: ‘*When an enterprise subject to corporation tax holds directly or indirectly at least 25% of the shares or rights in a company established in a foreign state or territory situated outside of France whose fiscal regime is privileged in the sense explained in Article 238A, that enterprise is subject to corporation tax on the profitable results [résultats bénéficiaires] of the foreign company in proportion to the interest it holds in it.*

*These profits [bénéfices] are subject to separate taxation. They are regarded as having been received on the first day of the month following the accounting date of the foreign company and are to be determined in accordance with the rules established by this Code.*

*Any tax paid locally by the foreign company is creditable in the proportion mentioned in the first paragraph against the tax imposed in France provided it is comparable to the corporation tax.’<sup>86</sup>*

The Conseil d’Etat specifies that, according to the wording of this article, the profits of the foreign company are attributed to the French taxpayer and there is not, as argued by the Ministry of Finance, a charge on the dividends deemed to be distributed to the French shareholder.

The term ‘profits’ is not defined within the France – Switzerland convention and consequently art. 3(2) applies. The court remarks that the context does not require otherwise and that, therefore, the meaning of the term ‘profits’ is to be determined under the relevant provisions of the code général des impôts. Accordingly, the court points out that there is identity between the concept of profits as applied in Switzerland and the same concept as applied in France.

<sup>85</sup> Austria, S. and Collet, M., *France*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 321.

<sup>86</sup> This is the translation of Article 209 B of the code général des impôts reported in *Re Société Schneider Electric- appeal no. 232 276*, in *International Tax Law Reports*, Vol. 4 (2002), No. 6, p. 1107. The following is the original French version of Article 209 B as applicable at the time of the judgment: ‘*Lorsqu’une entreprise passible de l’impôt sur les sociétés détient directement ou indirectement 25 % au moins des actions ou parts d’une société établie dans un Etat étranger ou un territoire situé hors de France dont le régime fiscal est privilégié au sens mentionné à l’article 238 A, cette entreprise est soumise à l’impôt sur les sociétés sur les résultats bénéficiaires de la société étrangère dans la proportion des droits sociaux qu’elle y détient. Ces bénéfices font l’objet d’une imposition séparée. Ils sont réputés acquis le premier jour du mois qui suit la clôture de l’exercice de la société étrangère et sont déterminés selon les règles fixées par le présent code.*

*L’impôt acquitté localement par la société étrangère est imputable dans la proportion mentionnée au premier alinéa sur l’impôt établi en France à condition d’être comparable à l’impôt sur les sociétés.’*

Profits taxed in Switzerland to Paramer are exactly those profits that, according to art. 209 B, should be taxed in France to Schneider. As a consequence, according to article 7(1) of the agreement between France and Switzerland, profits of the company resident in Switzerland cannot be taxed in France unless there is a permanent establishment. Art. 25(A)(1), which is the relief provision within the applicable treaty, assures that these profits are exempted in France.

The Conseil d'Etat states: '*[t]he objective of eliminating double taxation which is attributed to this tax treaty does not justify a misapplication of the provisions quoted above on the sole ground that the taxation in France of the profits of the Paramer company is not carried out in the name of the Swiss company but in that of its parent company which is a separate legal entity and to whom these profits have not in fact been distributed.*'<sup>87</sup>

Thus, according to the court, article 7(1), which is based on the distinction between two different legal entities, does not allow the application of art. 209 B of the code général des impôts exactly because it would determine taxation in France of profits that before their distribution can be taxed only in Swiss.

To conclude, the Conseil d'Etat emphasizes that the purpose of avoiding double taxation cannot justify the failure to apply art. 7(1) and, thus, a breach of the relevant treaty for the sole reason that France establishes taxation of profits in name of the French parent company instead that in name of the Swiss subsidiary. It is extremely important to note that according to the Conseil d'Etat, even if it was ascertained that the relevant treaty also had the purpose to curb tax avoidance and evasion, the possibility to derogate from treaty provisions should any way be expressly established within the treaty.

In a quite concise judgment the Conseil d'Etat has expressed a very clear position about the relationship between the French CFC legislation and tax treaties. As already emphasized, the court's interpretative approach is based on the 'subsidiarity principle'. It requires a preliminary evaluation of the scope of domestic legislation starting from the qualification of the taxable income. The effective meaning of art. 209 B of the code général des impôts was – in fact – controversial.

Its unclear character was emphasized during the proceedings by the Commissaire du Gouvernement<sup>88</sup>.

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<sup>87</sup> See *Re Société Schneider Electric- appeal no. 232 276*, in *International Tax Law Reports*, Vol. 4 (2002), No. 6, p. 1108. The following is the original French text: '*l'objectif d'élimination des doubles impositions attribué à cette convention fiscale ne saurait justifier une méconnaissance des stipulations susmentionnées au seul motif que l'imposition par la France des bénéfices de la société Paramer n'est pas établie au nom de la société suisse mais à celui de sa société mère, qui est une entité juridique distincte et à laquelle lesdits bénéfices n'ont pas été effectivement distribués*'. See Conseil d'Etat, Assemblée, du 28 juin 2002, 232276, *Ministre de l'économie, des finances et de l'industrie / Société Schneider Electric*, in [www.legifrance.gouv.fr](http://www.legifrance.gouv.fr).

<sup>88</sup> The 'Commissaire du Gouvernement' is a member of the French administrative jurisdiction. This official's role is to give – with complete impartiality – his or her opinion, as well as proposing a solution for the case, before a judge on matters that are subject of proceedings in which he or she is involved. The role of the 'Commissaire

First of all, he took into consideration the wording of art. 209 B<sup>89</sup>. According to this provision the parent company resident in France ‘is subjected to corporate income tax on the profits of the foreign corporation in proportion to its participation’. In addition, the profits of the foreign corporation are computed according to the rules established by French Code itself. The Commissaire du Gouvernement also argued that art. 209 B could be interpreted as meant to avoid double taxation. Nevertheless, the article specifies that the profits ‘are object of a separate taxation’<sup>90</sup> which implies that the foreign losses are not deductible in France. More importantly, according to the second paragraph of art 209BI ‘profits are deemed to be acquired’ by the French company.

The Commissaire du Gouvernement concluded that the interpretation of art. 209 B could not lead to an unequivocal solution about its meaning and scope. It could be correctly stated both that the provision at issue was based on the direct attribution of the profits of a foreign corporation to the French shareholders or that it was based on a deemed distribution of income.

Therefore, according to articles 31 and 33 of the Vienna Convention on the Law of Treaties, the Commissaire du Gouvernement gave more weight to the intention of the French legislator as resulting from the legislative history of the CFC legislation. Art 209 B of the code général des impôts was clearly meant to avoid double non taxation by using the parent subsidiary directive and, in general, its purpose was to tax in France profits of a subsidiary intentionally allocated in a country with a favourable tax regime<sup>91</sup>. The analysis concerning the intention of the French legislator as well as the object of the provision at issue led the Commissaire du Gouvernement to conclude that art. 209 B created a ‘legal presumption of distribution of foreign income to the French parent company.’<sup>92</sup>

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du Gouvernement’ is comparable to that of the Advocate General before the Court of Justice of the European Union.

<sup>89</sup> Gutmann, D., Danon, J. R. and Salome H., *French – Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law*, in Intertax (2003) Vol. 31, No. 4, pp. 160 – 161.

<sup>90</sup> See Kabbaj, H. and Raingeard de la Bletière, E., *National Report France*, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, p. 233: ‘[t]his particularity [separate taxation] stems from the territoriality principle and prevents French companies from offsetting the foreign entity’s losses against their French profits’. On the same page, in footnote No. 46 the authors explain about the territoriality principle: ‘Unlike French personal income tax, which is assessed on the worldwide earnings of the taxpaying individual, French corporation tax with respect to Art. 209 I is only assessed on earnings from enterprises engaged in business in France and those attributed to France.’

<sup>91</sup> See also See Kabbaj, H. and Raingeard de la Bletière, E., *National Report France*, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, p. 224.

<sup>92</sup> Gutmann, D., Danon, J. R. and Salome H., *French – Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in*

This case was considered to fall within the scope of art. 23 of the applicable treaty concerning ‘other income’. Consequently, the state of residence would have the right to tax.<sup>93</sup>

What is important to emphasize for our purposes is that in the end the Commissaire du Gouvernement suggested the Conseil d’Etat a conclusion of the case based on the anti-avoidance purpose of art. 209 B but this argument was explicitly refused by the court.

Furthermore, while the Conseil d’Etat excluded only incidentally the position of the Ministry of Finance which alleged the taxation of deemed distributed dividends under art. 209 B, much more relevance was given to the argument concerning the possibility that the anti-avoidance purpose of domestic legislation could justify a breach of an international treaty. This is considered possible by the Conseil d’Etat only when the parties have expressly agreed on it and thus a specific provision has been included in the tax treaty. These considerations of the Court precede the 2003 amendments to the Commentary to art. 1 of the OECD Model Convention when it was explicitly stated that one of the purposes of the Model Convention is to prevent tax avoidance and tax evasion. Nevertheless, this does not diminish the importance of the court’s statements which remain founded even when one considers the prevention of tax avoidance and evasion a purpose of tax treaties.

The court’s interpretative approach was very much appreciated by Gutmann, Danon and Salome who stated: ‘[t]here is no better way to reassert the principle of strict interpretation of international treaties.’<sup>94</sup> The authors emphasized the importance of the fact that the Conseil d’Etat, contrary to the Court of Appeal of Paris (which was competent in second instance and that any way denied the application of art. 209 B), considered it essential to qualify the taxable income according to French domestic law in order to establish the existence of a possible conflict with the applicable tax treaty<sup>95</sup>.

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*International Tax Law*, in Intertax (2003) Vol. 31, No. 4, p. 161. See also See Kabbaj, H. and Raingeard de la Bletière, E., National Report France, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 239 – 240.

<sup>93</sup> About the analysis of the Commissaire du Government during the proceedings of the Schneide case see Gutmann, D., Danon, J. R. and Salome H., *French – Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law*, in Intertax (2003) Vol. 31, No. 4, pp. 160 – 161.

<sup>94</sup> Gutmann, D., Danon, J. R. and Salome H., *French – Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law*, in Intertax (2003) Vol. 31, No. 4, p. 157. About the principle of strict interpretation of international treaties which is applied in France see references in the same article.

<sup>95</sup> Gutmann, D., Danon, J. R. and Salome H., *French – Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law*, in Intertax (2003) Vol. 31, No. 4, p. 159 *et seq.*

Vogel pointed out that the French Conseil d'Etat was right in emphasizing that, in fact, CFC legislation determines the taxation of business profits of a foreign company and this is in conflict with some of the fundamental principles on which double taxation conventions are founded<sup>96</sup>.

Bader does not agree with the French Conseil d'Etat since the court substantially excluded the applicability of the French CFC legislation on the basis of the identity between the profits taxable in France and the profits taxable in Swiss. Bader emphasizes that cases of economic double taxation are not covered by tax treaties based on the OECD Model Convention. CFC legislation does not causes juridical double taxation.

The point is that the Conseil d'Etat applied art. 7(1) of the relevant treaty and excluded the possibility, under that provision, to tax in France income that the treaty allocated to Swiss. The problem was not that the same income was taxed twice, but that, according to the French court, the relevant distributive rule recognized the right to tax only to the country of the corporation that produced the relevant income, unless there was a permanent establishment in the other contracting state. The Court did not apply art. 7(1) with the specific purpose to avoid economic double taxation. At the opposite, the avoidance of economic double taxation was only the natural consequence deriving from the exact – according to the French court – interpretation of art. 7(1).

As a consequence of the decision taken by the Conseil d'Etat in the Schneider case, the French CFC legislation was amended in 2005. It was made clear that art. 209 B of the code général des impôts concerns the taxation of deemed distributed dividends. Now, according to Austry and Collet the applicability of art. 209 B for tax treaty purposes depends on the interpretation of art. 10(5) of the OECD Model Convention. If this provision can be interpreted as also including the concept of deemed distributed dividends, art. 209 B should be considered applicable<sup>97</sup>. In this case the 2005 amendment to art. 209 B of the code général des impôts would constitute a tax treaty override.

The relationship between CFC legislation which is based on the deemed distribution of dividends and art. 10(5) of the OECD Model Convention will be analyzed below in this chapter.

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<sup>96</sup> Vogel, K., *France's Conseil D'Etat: Tax Treaties Prevail Over CFC Rules*, in Bulletin for International Taxation, Vol. 56 (2002) No. 10 (Tax Treaty Monitor: Tax Treaty News), p. 498.

<sup>97</sup> Austry, S. and Collet, M., *France*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 323.



## 8. The Finnish Supreme Administrative Court follows the OECD's position

Different again the position of the Finnish Supreme Administrative Court that in 2002 decided about the compatibility of the Finnish CFC regime<sup>98</sup> with a tax treaty entered into by Belgium and Finland in 1976.

The case<sup>99 100</sup> concerned the Finnish company Oyj Abp that directly owned a subsidiary incorporated in Belgium and qualified as a coordination centre benefiting of a favourable tax regime. The Belgian NV was a controlled foreign company under Finnish legislation.

However, the CFC Act<sup>101</sup> was passed only in 1994. According to the Court, it was not possible to establish whether the contracting parties had the intention of including CFC legislation within the scope of the international agreement only on the basis of the wording of the agreement itself. The Court focused on the interpretation of the OECD Commentaries. Although it specified that the Commentaries do not have binding effect, in the end the decision was entirely based on their interpretation.

First of all, the Court considered generally applicable to a treaty also OECD Commentaries modified subsequently to the treaty conclusion<sup>102</sup>. In the

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<sup>98</sup> For a general analysis of the Finnish CFC regime, see Helminen, M., *National Report Finland*, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 191 – 219.

<sup>99</sup> Supreme Administrative Court, 20 March 2002, KHO:2002:26. See *Re A Oyj Abp - KHO:2002:26*, in *International Tax Law Reports*, Vol. 4 (2002), No. 6, pp. 1009 – 1076 (with note of Philip Baker).

<sup>100</sup> Bader, R. G., *CFC Legislation in the European Union and the Alternative CSC Concept*, (thesis defended at Tilburg University), 2012, pp. 329 – 333; Lehtimaja, A., Finland, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, pp. 305 – 306; De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, pp. 454 – 458 / 603 – 604; Helminen, M., *National Report Finland*, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 204 – 207.

<sup>101</sup> Act on the Taxation of Shareholders in Controlled Foreign Companies (1217/1994, the CFC Act). See Lehtimaja, A., Finland, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 302.

<sup>102</sup> As emphasised in the part of this chapter specifically dedicated to the role of the OECD Commentary, the possibility to base the interpretation of a tax treaty on OECD Commentaries amended after the treaty conclusion is very controversial. About the position of the Finnish Supreme Administrative Court in the judgment at issue, see Lang, M., *CFC Regulations and Double Taxation Treaties*, in *Bulletin for International Fiscal Documentation*, (2003) Vol. 57, No 2, p. 52 and relevant quotations.



case at issue the Supreme Administrative Court considered the 1992 OECD Commentaries applicable. On the basis of this, the Court stated the possibility to apply the Finnish CFC Act. Adding that the 1992 OECD Commentary to art. 1 of the Model Convention was mainly based on the 1987 Base Companies Report, the Court took exactly the OECD position. The Court quoted the Commentary and stated that CFC legislation is *'part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability and that these rules are not addressed in tax treaties and are therefore not affected by them'*. It was, thus, stated that double taxation conventions do not prevent domestic application of anti-abuse provisions. On the other hand, tax treaties do not allow to guarantee any benefits when they are being abused by taxpayers. Furthermore, the majority of the OECD member states apply CFC legislation.

On these grounds, the Finnish Administrative Court excluded that art. 7(1) of the relevant tax treaty could preclude the application of the Finnish CFC Act.

It is worth noting that only indirectly the Court dealt with the fact that – in my opinion – a tax treaty override was actually realized.

The Court preliminarily stated the importance of establishing whether the intention of the parties at the moment of the conclusion of the treaty was to include CFC legislation. It was importantly noted that this intention needs to be evaluated on the basis of the wording of the relevant treaty. The fact is that the applicable tax treaty was concluded in 1976 (limited amendments were adopted in 1996 but they did not concern the matter at issue) and it could hardly be stated that at that time the parties had the intention to include CFC legislation within the scope of the tax treaty (the CFC Act was passed only in 1994). Ambiguously, the Court stated that the wording of the treaty did not consent any evaluation in this respect. From this consideration the Court derived the necessity to use the OECD Commentary. Arguing that the present OECD Commentary is always applicable as expression of the spirit of a tax treaty, the Court completely based its decision on the statements contained in the 1992 OECD Commentary to art. 1.

Nevertheless, according to the position taken in this study<sup>103</sup>, only the Commentaries current at the moment of the conclusion of a tax treaty can be considered part of the context of that tax treaty. In my opinion, therefore, the court could not base its decision on the new 1992 Commentary to art. 1 of the OECD Model Convention.

In this regard, another aspect needs to be emphasized, i.e. the 1992 OECD Commentary to art. 1 was admittedly not clear about the compliance of CFC regimes with the OECD Model Convention<sup>104</sup>. It exactly manifested the

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<sup>103</sup> See *infra* chapter IV.

<sup>104</sup> Ex multis, Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 84; Arnold, B. J., *Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model*, in Bulletin For International Fiscal Documentation, Vol. 58 (2004), No. 6, p. 252; Lang,

uncertainty of the 1987 Base Companies Report on the matter<sup>105</sup>. In both cases it was simply stated that the majority of the OECD member states applied CFC legislation without taking a clear position on the matter. As explained above, this position was clarified only in 2003<sup>106</sup>.

## 9. The Swedish Supreme Administrative Court explicitly ruled that CFC legislation can override existing tax treaties

In 2008, the Swedish Supreme Administrative Court realized a case of tax treaty override concerning the application of domestic CFC legislation. Specifically, the case at issue dealt with the tax treaty entered into by Sweden and Switzerland in 1976 (and incorporated within the Swedish national system in 1987).

In Sweden international law has not automatic and direct effect within the national legal system. An international treaty needs to be incorporated into national law by the Parliament. Only after incorporation an international treaty can be considered effective and, therefore, applicable within the national legal system<sup>107</sup>.

CFC legislation was firstly introduced in Sweden in 1990<sup>108</sup>. Since the cases of tax abuses increased, mostly after the introduction of a participation exemption regime, the Swedish CFC legislation was amended in 2004<sup>109</sup>. When the CFC legislation was firstly introduced in 1990, the prevailing opinion was that it was in breach of double taxation conventions. Consequently, CFC legislation was expressly provided to apply only to those countries with which there was no

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M., *CFC Regulations and Double Taxation Treaties*, in Bulletin for International Fiscal Documentation, (2003) Vol. 57, No 2, pp. 52-53.

<sup>105</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 587.

<sup>106</sup> The uncertainties that still characterize the OECD Commentary on art. 1 have been highlighted above in this chapter and will be further highlighted below.

<sup>107</sup> Wiman, B., *Tax Treaty Override – Swedish Developments*, in Baker, P. and Bobbet, C. (editors), *Tax Polymath – A life in international taxation. Essays in honour of John F. Avery Jones*, IBFD, 2010, pp. 249 – 250; Hilling, M., *The Swedish Supreme Administrative Court Totally Disregards Tax Treaty: A Critical Analysis of a CFC Judgment*, in Intertax, Vol. 36 (2008), No. 10, p. 458.

<sup>108</sup> Wiman, B., *Tax Treaty Override – Swedish Developments*, in Baker, P. and Bobbet, C. (editors), *Tax Polymath – A life in international taxation. Essays in honour of John F. Avery Jones*, IBFD, 2010, p. 250; Dahlberg, M., National Report Sweden, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, p. 596.

<sup>109</sup> Wiman, B., *Tax Treaty Override – Swedish Developments*, in Baker, P. and Bobbet, C. (editors), *Tax Polymath – A life in international taxation. Essays in honour of John F. Avery Jones*, IBFD, 2010, p. 250.

tax treaty<sup>110</sup>. As reported by Dahlberg, Sweden started to change its position as from 1992, when the Commentary to art. 1 was changed and interpreted by Sweden as supporting an interpretation that favoured the application of CFC rules<sup>111 112</sup>. In some tax treaties the absence of any conflict with domestic CFC legislation was expressly stated<sup>113</sup>. This position was confirmed by the Swedish legislator in the preparatory work to the 2004 CFC legislation. Arguing on the basis of the OECD Commentary to art. 1, the Swedish legislator excluded the existence of a conflict between CFC legislation and tax treaty provisions. This argument was considered founded independently of the fact that many tax treaties in force by that time had been already concluded before the OECD Commentary to art. 1 was amended in 2003. With a reasoning that recalls the above commented Finnish judgment, the OECD Commentaries were generally considered applicable also to previously concluded tax treaties. Commentaries

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<sup>110</sup> Hilling, M., *The Swedish Supreme Administrative Court Totally Disregards Tax Treaty: A Critical Analysis of a CFC Judgment*, in Intertax, Vol. 36 (2008), No. 10, p. 457; Dahlberg, M., National Report Sweden, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, p. 596.

<sup>111</sup> Dahlberg, M., National Report Sweden, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, p. 596 – 597. See also Hilling, M., *The Swedish Supreme Administrative Court Totally Disregards Tax Treaty: A Critical Analysis of a CFC Judgment*, in Intertax, Vol. 36 (2008), No. 10, p. 457.

<sup>112</sup> It is important to emphasize that, as already clarified above in this Chapter, the interpretation of the 1992 OECD Commentary to art. 1 was actually considered doubtful by the majority of scholars. According to them, the prevalence of domestic anti-abuse provisions – including CFC legislation – over treaty provisions could not be clearly deducted from the statements of the OECD. Ex multis, De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 587; Arnold, B. J. and Van Weeghel, S., *The Relationship Between Tax Treaties and Domestic Anti-abuse Measures*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 81 *et seq.*; Martín Jiménez, A. J., *The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A case for the Declining Effect of the OECD Commentaries?*, in Bulletin for international fiscal documentation, 2004, Vol. 58, No. 1, p. 17 *et seq.*; Martín Jiménez, A. J., *Domestic anti-abuse rules and double taxation treaties: a Spanish perspective – part I*, in Bulletin for international fiscal documentation, 2002, Vol. 56, No. 11, p. 542 *et seq.*; Martín Jiménez, A. J., *Domestic anti-abuse rules and double taxation treaties: a Spanish perspective – part II*, in Bulletin for international fiscal documentation, Vol. 56 (2002), No. 12, p. 620 *et seq.*

<sup>113</sup> Dahlberg, M., National Report Sweden, in Lang, M. – Aigner, J. – Scheuerle, U. – Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, p. 597.

were considered to have a merely interpretative function of already existing treaty provisions<sup>114</sup>.

The Swedish Income Tax Act excludes EU member states and some other countries from the application of CFC legislation<sup>115</sup>. The case of Switzerland is particular because the CFC legislation covers only insurance, banking and financing activities<sup>116</sup>.

The case at issue<sup>117 118</sup> concerned a Swiss insurance company which was directly held by a Swedish company. Swedish CFC legislation is based on an 'entity approach'. In particular, the profits of the controlled foreign corporation are taxed in the hands of the Swedish shareholders. It is important to recall that at issue was the applicability of Swedish CFC legislation which was adopted in 1990 and amended in 2004, while the relevant double taxation convention had been concluded in 1976 and incorporated in 1987.

The Supreme Administrative Court stated the possibility to apply CFC legislation, in particular to consider the Swiss assurance company as a CFC and consequently attributes to the Swedish taxpayer its profits. The Court emphasized that international treaties need to be incorporated into Sweden domestic law to be applicable. Incorporation is necessary notwithstanding Sweden is internationally bound upon the treaties that it has concluded. Sweden, exactly like Germany<sup>119</sup>, distinguishes between the international responsibility of a state and its obligation to domestically apply a treaty.

<sup>114</sup> Hilling, M., *The Swedish Supreme Administrative Court Totally Disregards Tax Treaty: A Critical Analysis of a CFC Judgment*, in Intertax, Vol. 36 (2008), No. 10, p. 457. See also Wiman, B., *Tax Treaty Override – Swedish Developments*, in Baker, P. and Bobbet, C. (editors), *Tax Polymath – A life in international taxation. Essays in honour of John F Avery Jones*, IBFD, 2010, pp. 250.

<sup>115</sup> Wiman, B., *Tax Treaty Override – Swedish Developments*, in Baker, P. and Bobbet, C. (editors), *Tax Polymath – A life in international taxation. Essays in honour of John F Avery Jones*, IBFD, 2010, p. 250.

<sup>116</sup> Wiman, B., *Tax Treaty Override – Swedish Developments*, in Baker, P. and Bobbet, C. (editors), *Tax Polymath – A life in international taxation. Essays in honour of John F Avery Jones*, IBFD, 2010, p. 250; Hilling, M., *The Swedish Supreme Administrative Court Totally Disregards Tax Treaty: A Critical Analysis of a CFC Judgment*, in Intertax, Vol. 36 (2008), No. 10, p. 457.

<sup>117</sup> Supreme Administrative Court, 3 April 2008, case 2655–05.

<sup>118</sup> See Bader, R. G., *CFC Legislation in the European Union and the Alternative CSC Concept*, (thesis defended at Tilburg University), 2012, p. 345 – 346; Wiman, B., *Tax Treaty Override – Swedish Developments*, in Baker, P. and Bobbet, C. (editors), *Tax Polymath – A life in international taxation. Essays in honour of John F Avery Jones*, IBFD, 2010, pp. 249 – 256; Benktsson, A. and Johansson, A., Sweden, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, pp. 761 – 762; Hilling, M., *The Swedish Supreme Administrative Court Totally Disregards Tax Treaty: A Critical Analysis of a CFC Judgment*, in Intertax, Vol. 36 (2008), No. 10, p. 457.

<sup>119</sup> See *infra* Chapter II.

The Supreme Administrative Court, therefore, checked the correctness of the incorporation within the legal system of the tax treaty concluded between Sweden and Switzerland. It, thus, argued that, following their incorporation, international treaties acquire within the national hierarchy of law the same rank of the incorporating law. The consequence is the possible application of the rule *lex posterior abrogat priori*. The Court explicitly excluded that laws incorporating international treaties are *leges speciales* thus prevailing on more general domestic legislation. The law enacting the Swedish CFC legislation could override the previous law incorporating the treaty entered into by Sweden and Switzerland. The Court also explained that this conclusion is not contradicted by the provision, which is contained in Section 2 of the law incorporating the relevant treaty<sup>120</sup>, according to which a tax treaty is applicable only to the extent that it limits national tax jurisdiction. This provision does not limit the national legislature to extend the national tax jurisdiction, regardless of the existence of a tax treaty. The Supreme Administrative Court realized a genuine case of tax treaty override. It did not even verify the existence of a conflict between CFC legislation and treaty provisions. Its reasoning was exclusively based on the effectiveness of international treaties within the national legal system. It is worth noting the stated possibility of extending the national tax jurisdiction regardless of existing treaty obligations. Indeed, given these premises, the Court had no necessity to interpret the tax treaty at issue and verify the possible existence of a conflict. The judgment of the Swedish Supreme Administrative Court has been strongly criticized by Swedish scholars that do not agree with the position of the Court allowing treaty override<sup>121 122</sup>.

Benktsson and Johansson stated: ‘*The reasons given by the Court are astonishingly brief, and one wonders whether the Court was fully aware of the consequences of the judgment and the complexity of the issue. Allowing domestic provisions to be applied in a situation such as the one examined in the case should have required some degree of support in the applicable treaty, or at least a more thorough and convincing reasoning than the one provided by the Court.*’<sup>123</sup>

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<sup>120</sup> As reported by Wiman this provision is usually included in Swedish incorporating laws. See Wiman, B., *Tax Treaty Override – Swedish Developments*, in Baker, P. and Bobbet, C. (editors), *Tax Polymath – A life in international taxation. Essays in honour of John F. Avery Jones*, IBFD, 2010, p. 250.

<sup>121</sup> See Wiman, B., *Tax Treaty Override – Swedish Developments*, in Baker, P. and Bobbet, C. (editors), *Tax Polymath – A life in international taxation. Essays in honour of John F. Avery Jones*, IBFD, 2010, p. 252 where the different positions are synthesized.

<sup>122</sup> On the contrary this position is supported by the Swedish tax administration. See Benktsson, A. and Johansson, A., Sweden, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 761.

<sup>123</sup> Benktsson, A. and Johansson, A., Sweden, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 761.

Likewise, Hilling criticized the fact that the Court did not interpret the treaty at issue so that, in fact, it did not verify whether the treaty limited the possibility to apply domestic CFC legislation<sup>124</sup>.

# **10. Some ‘intermediate’ reflections on the position of the OECD member states concerning the relationship between CFC legislation and tax treaty provisions**

The examined case law has showed – in line with the country analysis conducted in the second chapter of the present study – that – in fact – states autonomously follow their approach concerning the relationship between national law – in this case CFC legislation – and international law.

The position taken by the OECD has actually offered some states the possibility to justify an indiscriminate application of their CFC regimes on the sole basis that the OECD Commentaries have excluded the possibility of any conflict with tax treaties based on the OECD Model Convention. The Finnish and Swedish judgments lack a real legal reasoning. They uncritically repeated what the OECD Commentary to art. 1 states without taking into consideration the specific facts at issue and without evaluating whether a conflict – in fact – existed between the CFC regime at issue and the relevant treaty.

The position of the British Court of Appeal was quite strong in the application of a statutory fictitious residence that actually prevented the application of a tax treaty. Moreover, the court stated that the application of fictions is allowed as long as the will of the national legislature is respected. However, limits to the will of the legislature should exist.

The French judgment clearly reflects the position of France against treaty override. Nevertheless, a tax treaty override was possibly realized in 2005 if art. 209 B of the code général des impôts will be interpreted as allowing taxation in France of deemed dividends.

Indeed, the primary ‘instinct’ of states is to preserve their own tax base. It would be naïve not to accept and understand this.

Cases of abuse cannot be accepted. But, international relations need to be protected as well on the basis of a lawful application of the undertaken international obligations. The solution needs to be a meditated one and cannot be based on a position which is clearly the result of a compromise.

In the following paragraphs, the position of the OECD will be examined in order to establish whether – in fact – CFC legislation does not affect international tax treaties which are based on the OECD Model Convention. The purpose is to verify whether tax treaties actually limit state sovereignty in order to apply CFC legislation.

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<sup>124</sup> Hilling, M., *The Swedish Supreme Administrative Court Totally Disregards Tax Treaty: A Critical Analysis of a CFC Judgment*, in Intertax, Vol. 36 (2008), No. 10, p. 460.

The analysis will deal with CFC regimes based on a so-called ‘entity approach’. This approach is mainly based on the location of the controlled foreign corporation in a country where a favourable tax regime is guaranteed. This approach aims at avoiding the use of favourable tax regimes, regardless of the specifically earned item of income.

On the basis of the results of the present analysis, which have a general scope, in chapter six the then developed ‘interpretative model’ will be concretely applied to the so-called ‘transactional approach’. This method is characterized by the fact that only specific items of income are covered by the CFC regime at issue<sup>125</sup>.

### **11. Is art. 7(1) of the OECD Model Convention really unaffected by CFC legislation ?**

Specific purpose of this paragraph is to analyze the position of the OECD concerning the compliance of CFC legislation with art. 7(1) of the Model Convention. The focus is on CFC legislation based on an ‘entity approach’ and that uses a ‘transparency’ method. Being the CFC considered transparent, income is directly attributed to the CFC’s foreign shareholders. The attribution of income can concern a notional amount (like in the Bricom case) or business profits according to the interpretation that the Conseil d’Etat gave of art. 209 B of the code général des impôts in the Schneider case.

As already clarified, according to paragraph 23 of the OECD Commentary to art. 1, CFC legislation is not contrary to art. 7(1) of the OECD Model Convention either on the basis of its wording and on the basis of its context. Paragraph 23 of the Commentary to art. 1 recalls paragraph 13 of the Commentary to art. 7. Paragraph 13 states literally: *‘The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents’ participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10).*

Substantially, the position of the OECD is based on the fact that the attribution of the taxable object to the taxable subject only concerns each contracting state’s

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<sup>125</sup> For an in depth analysis about the different approaches characterizing CFC legislation, see Bader, R. G., *CFC Legislation in the European Union and the Alternative CSC Concept*, (thesis defended at Tilburg University), 2012; Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004.



domestic law and it is not addressed within tax treaties. Therefore, the application of CFC legislation does not involve tax treaties. Paragraph 13 of the OECD Commentary to art. 7 allows to compute the profits attributable to the foreign shareholder according to the rules applicable in its residence state.

As already mentioned, in fact, the fundamental position of the OECD concerning the compliance of CFC legislation with the OECD Model Convention reflects its general position about the relationship between treaty provisions and domestic anti-abuse provisions. The determination of the taxable event which gives rise to tax liability falls within each contracting state sovereignty and, therefore, tax treaties are not addressed.

The OECD position is supported by prominent scholars. Lang emphasizes that the concept of income as well as its attribution to taxpayers become concrete only under domestic law: “[i]ncome within the meaning of a tax treaty is nothing actual. On the contrary income exists when the tax system describes an actual circumstance and links it to a legal consequence in connection with a tax income ... Even the amount of income is nothing actual but requires a legislative order ... In the same way the attribution of income is not a matter of actuality. Rather the legal system determines this. It is in the hands of the legislature which – considering the relevant constitutional provisions – may either follow the civil law attribution or to establish independent attribution criteria.”<sup>126</sup>

The position of the OECD as well as of the authors that agree with its view is efficaciously synthesized by De Broe<sup>127</sup>: *‘[i]t is the sovereign right of the State of the shareholder of the CFC to consider this shareholder (who is a resident of that State and thus falls within that State’s unrestricted tax jurisdiction) separately from the CFC and to decide whether and to what extent CFC income is to be attributed to the shareholder*

<sup>126</sup> Lang, M., *CFC Regulations and Double Taxation Treaties*, in *Bulletin for International Fiscal Documentation*, (2003) Vol. 57, No 2, pp. 53 -54.

<sup>127</sup> It is important to specify that De Broe’s point of view is partially different than the position he aptly described in the mentioned passage. He wrote: *‘I share the views expressed above that it is the sovereign right of each State to freely determine the taxable object (the taxable income); the taxable subject to whom that income will be attributed (the taxpayer); the taxable event; the timing when income will be taxed, etc. I also share the view that the income attribution rules belong to the sphere of domestic law and that they are not addressed in treaties. And of course, States can take unilateral measures to prevent tax avoidance; tax deferral; double non-taxation, etc. and to preserve the equity and neutrality of their tax systems. However, I do not share the view that such anti-avoidance measures are unaffected by tax treaties and are always treaty-proof. The result of a redetermination of the taxpayer and/or a recharacterization of income under CFC legislation can only be given effect for treaty purposes if such result is supported by the terms of the treaty, viewed in their context and in light of the object and purpose of the provisions of the treaty or of the treaty as a whole ... In my view it is also not correct to say that the income attribution decisions made by States are left unaffected by the tax treaties. If a State has entered into a tax treaty, the provisions of such a treaty may restrict the rights of such State to attribute income and to tax income to a resident of such State, if such income is also attributed to a taxpayer resident of another Contracting State.’* See De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 605.



and how and when the shareholder will be taxed on it. The income attribution decision of the State of residence of the CFC must be considered independently from the attribution decision of the State of residence of the shareholder. The latter is not precluded by a tax treaty to attribute the CFC income to the shareholder, even if all or part of that income is attributed by the State of residence of the CFC to the CFC.<sup>128</sup>

And furthermore: ‘From the perspective of the State of residence of the CFC, CFC legislation respects Art. 7 OECD MC. Art. 7 OECD MC (jo. Art. 23 OECD MC) does not restrict the taxing rights of that State as regards the CFC, unless the CFC has a permanent establishment in the State of residence of the shareholder (*quod non in casu*). From the perspective of the state of residence of the shareholder of the CFC, there is no breach of Art. 7 OECD MC either. That State does not tax the CFC and thus does not infringe the rule laid down in Art. 7 according to which the profits of the CFC cannot be taxed in that State, unless the CFC has a permanent establishment there (*quod non in casu*). The residence State of the shareholder imposes tax on the shareholder (albeit on all or part of the CFC income) but that right is not restricted by Art. 7 OECD MC...’<sup>129 130</sup>

The focal aspect of our analysis is, therefore, to verify whether, in fact, art. 7(1) of the OECD Model Convention does not affect the attribution of the taxable income to the taxable subject so that both elements can autonomously be determined by the state that applies CFC legislation. Also in this case it is important to delimit exactly the extent to which the contracting states’ taxing power has been limited through the applicable distributive rule.

To this purpose, the model of distributive rule as elaborated by Vogel<sup>131</sup> is useful. The application of this model permits to clearly individuate the different elements constituting the OECD Model Convention distributive rules and to verify to what extent they affect domestic law.

In the following, the elements of the distributive rule model are in ‘normal’ dark characters while the provisions of article 7(1) of the OECD Model Convention are highlighted in bold characters. Moreover, we take into consideration only

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<sup>128</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 579.

<sup>129</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 580.

<sup>130</sup> See Favi, L., *National Report Italy*, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 363 – 364; IFA Congress Seminar Series (Vol. 19c), *How Domestic Anti-Avoidance Rules Affect Double Taxation Conventions* – Proceedings of a Seminar held in Toronto in 1994 during the 48<sup>th</sup> Congress of the International Fiscal Association (Chair: Mr. David Ward Q. C. (Canada)), Kluwer Law International, 1995, pp. 24 – 26. See also Avi-Yonah, R. S., *International Tax as International Law – An Analysis of the International Tax Regime*, Cambridge Tax Law Series, Cambridge University Press, 2007, pp. 22 – 37.

<sup>131</sup> Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 29.

part ‘**II Substantive requirements**’ of Vogel’s model. This part is the only relevant to our purpose:

## II Substantive requirements

1. Designation of the particular object under internal tax law to which the rule will apply (the ‘*Objekttatbestand*’ such as ‘income’, ‘profit’, ‘capital’, etc.)  
**> profits**
2. Designation of the particular requirements under which the distributive rule will apply (the ‘*Metatattbestand*’):
  - a) Designation of certain characteristics of the tax object that give rise to tax liability: the ‘source’ (‘income from immovable property’, ‘profits of an enterprise’) **> profits of an enterprise**
  - b) Designation of certain characteristics of the tax object that determine how the amount of tax liability is measured (Swiss literature refers to this as ‘tax separation’ (*Steuerausscheidung*), i.e. exclusion from taxation of certain items of income **> profits of permanent establishment are taxed in the state where the permanent establishment is situated**
3. Connection between the *Metatattbestand* and the taxpayer: ‘attribution of tax object’ (‘income derived by a resident’) **> profits of an enterprise of a Contracting State shall be taxable only in that State**
4. Connection between the *Metatattbestand* and the taxing State(s): ‘connecting factor’ either
  - a) by a characteristic of the taxpayer (residence, citizenship), or
  - b) by characteristics of the transaction or event (e.g. the situs of immovable property) **> residence**

There are two aspects which are decisive in determining whether art. 7(1) affects the power of the state that applies CFC legislation to autonomously identify the taxable income and the taxable subject. They are (a) the ‘*designation of certain characteristics of the tax object that give rise to tax liability*’ and (b) the ‘*attribution of tax object*’. Both elements clearly show that distributive rules actually govern factors that give rise to tax liability as well as the ‘*attribution of tax object*’. From the application of the model of distributive rule to art. 7(1) it is clear that the treaty provision at issue establishes a unique connection, in terms of tax liability, on the one hand, between the taxable income and the subject that has produced that income (which is the only possible taxable subject in connection to that income) and, on the other hand, between the taxable subject and the state that has the power to tax (which can only be the state of residence of the corporation that has produced the relevant income). All this results in the perfectly clear provision of art. 7(1) according to which ‘*profits of an enterprise of a Contracting State shall be taxable only in that State*’.

In other terms, art. 7(1) determines in an exclusive way the attribution to a taxable subject (a resident corporation) of a taxable object (the profits of that corporation).

It cannot, therefore, be rightly stated that art. 7(1) does not affect the facts that give rise to tax liability and consequently that this liability can autonomously be attributed to another subject which is moreover resident in another state.

According to Wattel and Marres, ‘*Art. 7 of the OECD Model **allocates [emphasis added] the taxation of company profits exclusively to the company’s residence state unless there is a permanent establishment in the other state ...***’<sup>132</sup>

Vogel as well, interprets art. 7(1) as exclusively attributing the taxing right to the state of residence of the CFC on its profits, while the state of residence of the parent company is obliged to guarantee exemption since art. 7(1) is a ‘complete’ distributive rule<sup>133</sup>.

Gutmann, Danon and Salome explicitly state that art. 7(1) attributes a taxable object to a taxable subject through the sentence ‘profits of an enterprise’. Moreover, the authors specified that this is a common feature of the OECD Model distributive rules that use to attribute taxable income to a taxable subject<sup>134</sup>.

This confirms that distributive rules usually deal with the facts that give rise to tax liability. Vogel states: ‘[t]he requirements for application of the distributive rules are ... **additional requirements [Vogel’s emphasis] for establishing tax liability, aside from those of domestic law.**’<sup>135</sup>

To conclude, Martín Jiménez clearly stated ‘*The OECD’s argument that CFC rules form part of the rules that define the taxable event and are therefore not affected by tax treaties lacks a solid foundation. **The substantive provisions of treaties do affect the taxable event, especially, the geographic aspect of the taxable event (e.g. it limits the source rules or the geographic effect of the residence principle) [emphasis added].** It seems that, by using the back door of the Commentary on Art. 1 of the OECD Model, the tax administrations attempted to create exceptions to principles already established in existing treaties or other articles of the OECD Model (e.g. Art. 7).*’<sup>136</sup>

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<sup>132</sup> Wattel, P.J. and Marres, O., *Characterization of Fictitious Income under OECD-Patterned Tax Treaties*, in *European Taxation*, Vol. 43 (2003), No. 3, p. 75.

<sup>133</sup> Vogel, K., *France’s Conseil D’Etat: Tax Treaties Prevail Over CFC Rules*, in *Bulletin for International Taxation*, Vol. 56 (2002), No. 10 (*Tax Treaty Monitor: Tax Treaty News*), p. 498 (and especially footnote No. 2).

<sup>134</sup> Gutmann, D., Danon, J. R. and Salome H., *French – Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law*, in *Intertax*, Vol. 31 (2003), No. 4, p. 158.

<sup>135</sup> Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 31.

<sup>136</sup> Martín Jiménez, A. J., *Domestic anti-abuse rules and double taxation treaties: a Spanish perspective – part II*, in *Bulletin for international fiscal documentation*, Vol. 56 (2002), No. 12, p. 625.

The conclusion according to which art. 7(1) of the OECD Model Convention affects the tax liability of the foreign shareholder and, therefore, limits the taxing power of the state that applies the CFC legislation leads to the consequence that art. 7(1) is the parameter under which the legitimacy of the CFC regime needs to be evaluated. The interpretation of art. 7(1) is, therefore, necessary to establish to what extent art. 7(1) affects the tax liability of the CFC's foreign shareholder. The term 'profits' is not defined within the OECD Model Convention, therefore, art. 3(2) must be applied. It is important to recall that the application of this provision is mandatory every time an undefined treaty term needs to be interpreted. Furthermore, the analysis concerning art. 3(2) conducted in the fourth chapter has showed that according to art. 23 of the OECD Model Convention, the application of art. 3(2) is based on the use of terms as qualified by the state of source when the context does not require otherwise. Lacking a contextual definition of 'profits', the term is to be applied according to the qualification given by the state of source (which is the state of residence of the CFC) even when it is the state of residence of the foreign shareholders that is applying the treaty. It was, therefore, correct the position of the Conseil d'Etat that in the *Schneider* case first of all qualified the taxable income under art. 209 B of the code général des impôts to verify the possible relevance of one of the distributive rules of the applicable treaty. Once established the relevance of art. 7(1), the court verified the coincidence of the French notion of 'profits' with the same notion as applied under Swiss law and concluded that, in fact, the profits of the Swiss subsidiary were to be taxed in France. The problem was not, therefore, a problem of economic double taxation but only of interpretation of art. 7(1). According to the provision at issue the French Court attributed the power to tax the profits of the CFC exclusively to Switzerland because that is the only state that, according to art. 7(1), has the right to tax.

It has been demonstrated that art. 7(1) affects the taxpayer's liability and does not allow a parallel taxation in the state of residence of the foreign shareholder. Given that art. 7(1) affects the liability of the foreign shareholder and limits the taxing power of the state that wants to apply the CFC legislation, art. 7(1) becomes the distributive rule which is the parameter to establish whether a certain CFC regime is compatible with the provision at issue. Art. 7(1) needs to be interpreted. The notion of profits needs to be determined according to art. 3(2).

This explains the position of the French Conseil d'Etat.

The first important conclusion is, therefore, that it cannot be sustained that art. 7(1) of the OECD Model Convention does not affect the attribution of taxable income to a taxable subject. The attribution is clearly established by the tax treaty provision at issue. The attribution is reserved to the CFC state of residence on the CFC profits as qualified under the domestic law of the state where they originate.

In substance, no parallel attribution of taxable income to taxable subject is possible under art. 7(1) of the OECD Model Convention because this provision limits the sovereignty of the other contracting state to do so.

This case needs to be distinguished from that in which application of CFC legislation is based on the deemed residence of the controlled foreign corporation in the state that applies the CFC legislation. In this last case taxation is based on a fiction about residence which avoids the above examined conception based on the sovereign attribution of a taxable income to a taxable subject

Indeed, each contracting state determines who is resident within its own jurisdiction. This is the main argument on which the Bricom case is based. As already emphasized, the important characteristic of the British CFC legislation is that its application is based on a fictitious residence. According to paragraph 1(1) of schedule 24 a controlled foreign company ‘*shall be assumed to be resident in the United Kingdom*’.

This possibility is, in principle, not excluded by the OECD Base Company Report according to which a deeming provision that allocates the place of effective management in the shareholder’s state of residence does not overrule treaty provisions<sup>137</sup>.

Such a consideration needs, however, to be coordinated with the OECD’s position concerning the concept of residence – i.e. liability to tax – for treaty purposes.

In 1992 the Commentary to art. 4(1) of the OECD Model Convention has been amended to introduce some remarks, as resulting from the 1987 Conduit Companies Report, about the interpretation of the notion of ‘liable to tax’ in connection with conduit companies. The 2008 addition to the Commentary to art. 4(1) concerning double residence and its effect on the relationship between the losing state and third states has not modified the matter at issue.

According to art. 4(1), second sentence, the term ‘resident of a Contracting State’ ‘*does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.*’

Paragraph 8.2 of the Commentary to art. 4(1) specifies: ‘*According to its wording and spirit the second sentence also excludes from the definition of a resident of a Contracting State foreign held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies. It also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State’s tax law, are considered to be residents of another State pursuant to a treaty between these two States. The exclusion of certain companies or other persons from the definition would not of course prevent Contracting States from exchanging information about their activities (see paragraph 2 of the Commentary on Article 26). Indeed States may feel it appropriate to develop*

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<sup>137</sup> OECD, *Double Taxation Conventions and the Use of Base Companies*, OECD 1987, par. 35.

*spontaneous exchanges of information about persons who seek to obtain unintended treaty benefits.'*

The following paragraph 8.3, nevertheless, immediately points out the difficulties concerning the interpretation of the second sentence of art. 4(1): *'The application of the second sentence, however, has inherent difficulties and limitations. It has to be interpreted in the light of its object and purpose, which is to exclude persons who are not subjected to comprehensive taxation (full liability to tax) in a State, because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended.'*

The OECD Conduit Companies Report specifies that these interpretative difficulties concern conduit companies as well *'... there is an element of uncertainty concerning its application against conduit companies. Furthermore to be effective, such provisions should also apply where the conduit company is fully exempt from tax under specific privileges even though they cannot cover the stepping stone situation ... or cases where the special status is not based on exemption of income.'*<sup>138</sup>

According to Vann, *'The focus of the second sentence on foreign-source income suggests that it only applies when a person who is a resident under the first sentence is entirely exempt on and only on foreign-source income (again with a qualification if one treaty partner has a territorial tax system).'*<sup>139</sup>

This means that only under the condition that the CFC is totally exempted from taxation in the state of its residence a fiction can apply and the place of effective management can be deemed to be located in the taxpayer's state of residence.

Vann further explains that the wording of the Commentary, in fact, determines limited possibilities to exclude the residence of a conduit company. It is extremely rare that a state grants a total exemption from taxes. *'Dividends are likely to benefit and not be taxed in the residence country of the conduit under a participation exemption or the like, but other foreign income, including interests, royalties and/or management fees that are often of concern in the conduit company context, may well remain (potentially) liable to taxation and be the subject of a stepping stone strategy (in which case it is the tax by the conduit country on outgoing flows that matters to the strategy).'*<sup>140</sup>

Certainly, the UK deemed residence provision could not apply in the Bricom case, considering that Spinneys was not completely exempted from taxation in the Netherlands.

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<sup>138</sup> OECD, *Double Taxation Conventions and the Use of Conduit Companies*, OECD 1987, par. 14.

<sup>139</sup> Vann, R., *"Liable to Tax" and Company Residence under Tax Treaties* (Chapter 7), in Maisto, G. (editor), *Residence of Companies under Tax Treaties and EC law*, EC and International Tax Law Series, Vol. 5, IBFD, 2009, p. 259.

<sup>140</sup> Vann, R., *"Liable to Tax" and Company Residence under Tax Treaties* (Chapter 7), in Maisto, G. (editor), *Residence of Companies under Tax Treaties and EC law*, EC and International Tax Law Series, Vol. 5, IBFD, 2009, p. 255.

## 12. CFC legislation: the compliance of fictitious income with articles 10(5) and 21 of the OECD Model Convention

This paragraph deals with CFC regimes which are based on an ‘entity approach’ and deem that the controlled foreign corporation has distributed dividends to the foreign shareholder(s).

Paragraph 23 of the OECD Commentary to art. 1 excludes that CFC legislation is in conflict with art. 10(5) of the OECD Model Convention. This provision establishes: *‘Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.’*

Paragraph 36 of the OECD Commentary to art. 10(5) synthesizes this provision with one sentence: *‘Paragraph 5 further provides that non-resident companies are not to be subjected to special taxes on undistributed profits’*. This single sentence concisely explains the content of the following paragraph 37: *‘It might be argued that where the taxpayer’s country of residence, pursuant to its controlled foreign companies legislation or other rules with similar effect seeks to tax profits which have not been distributed, it is acting contrary to the provisions of paragraph 5. However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.’*

Starting point of the OECD is the non relevance of art. 10(5) when CFC legislation which is based on a deemed distribution of dividends applies. This position is explained by stating that the prohibition of taxing undistributed profits established in the provision at issue only concerns the state of source with reference to taxation of non-resident companies. The state where the profits arise cannot tax these profits as if they had been distributed to companies residents in the other contracting state. Art. 10(5) does not, therefore, include the case in which shareholders are taxed on undistributed profits in the state where they are resident.

However, paragraph 38 rises a doubt concerning the qualification of the income which is attributed to the taxpayers. According to the OECD, it is not clear whether ‘deemed dividends’, so qualified by the taxpayer’s state of residence, can correctly be characterized as ‘dividends’ under art. 10 of the OECD Model Convention. Being this qualification incorrect, art. 21 of the OECD Model would apply consequently to a qualification as ‘other income’. The problem mainly concerns the application of art. 23 of the OECD Model and the recognition of an exemption by the state of residence. Paragraph 38 of the OECD Commentary to art. 10 specifies that under the OECD Model Convention it is not clear



whether, being income qualified as deemed dividends, the state of residence is obliged to an affiliation exemption. However, the Commentary recognizes that a denial of affiliation exemption would determine taxation of deemed dividends in advance and, therefore, would be in contrast with the normal operation of the OECD Model Convention<sup>141</sup>.

It is important to emphasize that, except from the specific relationship between CFC legislation and art. 10(5), the OECD admits the relevance of a tax treaty when CFC legislation is based on the deemed distribution of dividends to the taxpayer resident in the other contracting state.

The deemed flow of income from the state of source to the state of residence of the shareholder imposes the necessity to identify the applicable treaty provision to guarantee a correct application of the treaty under art. 23. As explicitly stated in paragraph 38 of the Commentary to art. 10, this is necessary regardless of the qualification made by the state of residence of the shareholder.

When CFC legislation is based on the qualification of the taxable income as deemed dividends, starting point of the analysis aimed at ascertaining its compliance with the OECD Model Convention is the interpretation of art. 10. Art. 10(3) of the OECD Model Convention defines the term ‘dividends’. It states: *‘[t]he term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident’*.

This definition needs to be considered in connection with the first paragraph of art. 10 which refers to dividends ‘paid’ by a company of a contracting state to a resident of the other contracting state.

Clearly, the use of the verb ‘paid’ rises doubts about the possibility that deemed dividends fall within the scope of art. 10 of the OECD Model Convention.

The term ‘paid’ is not defined within the text of the OECD Model Convention. This determines the application of art. 3(2). It is widely accepted that this is a case when the context requires otherwise since the concept of payment is clearly

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<sup>141</sup> Paragraph 38 of the OECD Commentary to art. 10 states: *‘The application of such legislation or rules may, however, complicate the application of Article 23. If the income were attributed to the taxpayer then each item of the income would have to be treated under the relevant provisions of the Convention (business profits, interest, royalties). If the amount is treated as a deemed dividend then it is clearly derived from the base company thus constituting income from that company’s country. Even then, it is by no means clear whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 or as “other income” within the meaning of Article 21. Under some of these legislation or rules the taxable amount is treated as a dividend with the result that an exemption provided for by a tax convention, e.g. an affiliation exemption, is also extended to it. It is doubtful whether the Convention requires this to be done. If the country of residence considers that this is not the case it may face the allegation that it is obstructing the normal operation of the affiliation exemption by taxing the dividend (in the form of “deemed dividend”) in advance.’*



defined within the OECD Commentary and its definition can be considered as expression of the intention of the treaty parties.

Paragraph 7 of the OECD Commentary to art. 10 states that ‘... [t]he term “paid” has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or by custom’.

Exactly the same formula is used with regard to article 11 of the OECD Model Convention and expressed in paragraph 5 of its Commentary. This wide concept of payment is confirmed in paragraph 8.3 of the OECD Commentary to art. 12 where it is stated almost identically that ‘[t]he word “payment”, used in the definition, has a very wide meaning since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom.’

In the light of the OECD Commentary’s statements, Wattel and Marres conclude: ‘Thus, the drafters [of the OECD Model Convention] assume that there is a “disposal”, which requires a real increase in the power of disposition of the taxpayer.’<sup>142</sup>

And De Broe confirms: ‘It follows that “payment” assumes in any case the fulfilment of an obligation: the real transfer of assets, value, economic benefit or advantage from one party to another ... There is no suggestion in the Commentary that the term includes fictitious earnings or distributions. On the contrary there are several indications in the Commentary that the term refers to an actual payment.’<sup>143</sup>

It is also important to remark that, according to some authors, art. 10 is applicable to deemed dividends as well. Lang points out that, according to art. 10(3) of the OECD Model Convention, dividends derive from companies that distribute them. Art. 3(1)(b) of the OECD Model Convention defines a company for treaty purposes as ‘any body corporate or any entity that is treated as a body corporate for tax purposes’. A company is, therefore, a legal entity whose existence is, for being created by law, only based on a fiction. ‘Since it is a legal entity - and therefore a fiction - that “pays” dividends, the term “paid” is obviously not only used in the context of real situations.’<sup>144</sup> In the opinion of Lang fiction is everything the legislature has

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<sup>142</sup> Wattel, P.J. and Marres, O., *Characterization of Fictitious Income under OECD-Patterned Tax Treaties*, in *European Taxation*, Vol. 43 (2003), No. 3, p. 68.

<sup>143</sup> De Broe, L., *International Tax Planning and Prevention of Abuse – A Study Under Domestic Tax Law, Tax Treaties and EC Law in Relation to Conduit and Base Companies*, IBFD Doctoral Series, Volume 14, IBFD, 2008, p. 624. See also Aigner, J., Scheuerle, U. and Stefaner, M., General Report, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, p. 35.

<sup>144</sup> Lang, M., “Fictitious Income” and tax treaties, in Van Arendonk, H. and Ellis, M. J., *A Tax Globalist - The search for the borders of international taxation - Essays in honour of Maarten J. Ellis*, IBFD Publications BV, 2005, p. 47. See also Lang, M., *CFC Regulations and Double Taxation Treaties*, in *Bulletin for International Fiscal Documentation*, (2003) Vol. 57, No 2, pp. 55 – 56; Aigner, J., Scheuerle, U. and Stefaner, M., General Report, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC*

created as such and, therefore, it is only up to the legislature to establish what a company is and what income is. Therefore, the legislature can decide that a fictitious entity distributes fictitious income.

However, it is worth noting that the fact that a company is a legal entity does not imply that it is a fiction. Certainly, the existence of a company is based on a legal provision. Nevertheless, the term fiction implies something that does not concretely exist. The same is true for income. Indeed, it is up to the domestic legislature to establish what income is. However, as it is also emphasized by Wattel and Marres, one has to distinguish between notional income which is based on an existing value (lump-sum) and income which is based on a 'pure'<sup>145</sup> fiction. In this last case a reference to a certain economic value is missing at all<sup>146</sup>. The deemed distribution of income that CFC legislation implies is a pure fiction in respect to which an economic value of reference is completely missing.

Most importantly, the position according to which art. 10 also covers deemed distribution of dividends does not take into consideration the fact that art. 3(2), as widely explained in the fourth chapter of this study, imposes to follow a specific interpretative process. When a term which is used in a distributive rule is not defined within the treaty text, art. 3(2) 'shall' apply. This provision prohibits the application of domestic law when the treaty context otherwise requires.

With regard to art. 10, the inclusion of deemed dividends within its scope necessarily implies to establish the exact meaning of the term 'paid'. The structure of the distributive rule has made the term 'paid' as a constituent element of the definition of dividend within art. 10(3). Since the commentary is clear when it states that the term payment implies *to put funds at the disposal of the shareholder*, it cannot be maintained that the treaty context allows CFC legislation which is based on a deemed distribution of dividends under art. 10 of the OECD Model Convention.

It is consequently necessary to evaluate whether CFC legislation can apply under the 'other income' treaty provision. The point is whether deemed distributed dividends fall within the scope of art. 21 of the OECD Model Convention.

Art. 21(1) states '*[i]tems of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.*' In this case the term 'income' has a crucial function. It has already been clarified that it includes also 'pure' fictions and, therefore, income which is not based on an economic value. Art. 21 allows taxation of income which is not based on a real economic value.

This is also proved by using Vogel's model of distributive rule:

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*Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 35 – 36.

<sup>145</sup> The term 'pure' is used by the present author to indicate that a fiction does not refer to any economic value.

<sup>146</sup> Wattel, P.J. and Marres, O., *Characterization of Fictitious Income under OECD-Patterned Tax Treaties*, in European Taxation, Vol. 43 (2003), No. 3, p. 69.

## II Substantive requirements

1. Designation of the particular object under internal tax law to which the rule will apply (the ‘*Objekttatbestand*’ such as ‘income’, ‘profit’, ‘capital’, etc.)  
**> income**
2. Designation of the particular requirements under which the distributive rule will apply (the ‘*Metatattbestand*’):
  - a) Designation of certain characteristics of the tax object that give rise to tax liability: the ‘source’ (‘income from immovable property’, ‘profits of an enterprise’) **> income wherever arising**
  - b) Designation of certain characteristics of the tax object that determine how the amount of tax liability is measured (Swiss literature refers to this as ‘tax separation’ (*Steuerausscheidung*), i.e. exclusion from taxation of certain items of income **> paragraph 2 : exclusion of income deriving from a permanent establishment**
3. Connection between the *Metatattbestand* and the taxpayer: ‘attribution of tax object’ (‘income derived by a resident’) **> income of a resident of a contracting state**
4. Connection between the *Metatattbestand* and the taxing State(s): ‘connecting factor’ either
  - a) by a characteristic of the taxpayer (residence, citizenship), or
  - b) by characteristics of the transaction or event (e.g. the situs of immovable property) **> residence**

As already pointed out, there is a concept which is crucial in the interpretation of the distributive rule at issue. This is the concept of ‘income’. This concept is no further specified or limited within the wording of art. 21. In principle, the text of this provision allows the conception according to which a contracting state can attribute a fictitious income (not based on a real economic value) to a resident taxpayer. The distributive rule refers to the attribution of the taxable object to a taxable subject in the sentence ‘income of a resident of a contracting state’. The relationship is not, however, exclusive as it is in the case of art. 7(1). In this case art. 21 refers to income ‘whatever arising’.

Art. 21 is a so-called catch-all provision. It has the function to ‘close’ the system of the OECD Model Convention, i.e. to assure taxation of income that could not be taxed under the other distributive rules. This explains the vagueness of its wording which allows to include also income lacking a real economic value. What needs to be emphasized is that, even if it is accepted that art. 21 allows to tax fictitious income fictitiously attributed to a resident taxpayer, further evaluation is required about the admissibility of CFC legislation under art. 21 in order to verify if a case of tax treaty override has occurred.

Limits to the application of notional income under the OECD Model Convention have been defined in the previous chapter four of this study. An ambulatory interpretation concerning notional income can be accepted to the extent that the state amending domestic law after the conclusion of a treaty does

not unilaterally extend its taxing rights by determining a shift in the application of the appropriate distributive rule. The relevant item of income or capital needs to be qualified according to its very nature and on the basis of its very nature (i.e. regardless of the fictitious qualification) the relevant distributive rule is individuated. When the relevant distributive rule, as determined according to the very nature of the relevant item of income or capital, is not applicable because of the domestic amendment and this amendment has unilaterally attributed taxing rights to the amending state (while according to the distributive rule rightly applicable the taxing power would have been attributed to the other contracting state) a case of tax treaty override occurs.

With specific reference to CFC legislation based on the attribution of fictitious income, the possibility to apply art. 21 of the OECD Model Convention depends, therefore, on the consequences determined by the introduction of such a legislation. As pointed out above, the present analysis concerns CFC regimes based on an ‘entity approach’ which aim at taxing income deriving from the controlled foreign corporation without any specific distinction. Purpose of this kind of CFC legislation is to tax the *undistributed profits* of the controlled foreign corporation at a higher rate in the state of residence of the shareholder. This aspect was correctly emphasized by the Conseil d’Etat in the Schneider case.

On the basis of the very nature of the relevant income (i.e. business profits), art. 7 of the OECD Model Convention should apply.

This means that, when the introduction of CFC legislation after the conclusion of a tax treaty determines the application of art. 21 instead of art. 7, there is a unilateral extension of the taxing power in favour of the state of residence of the foreign shareholder (the state that wants to apply the CFC legislation) and, therefore, a case of tax treaty override occurs.

### **13. Concluding remarks: domestic anti-abuse rules affect tax treaty provisions**

This chapter has specifically treated the relationship between domestic anti-abuse provisions and treaty provisions with the aim of understanding whether the anti-abuse purpose of domestic legislation allows the contracting states to apply anti-abuse provisions regardless of the existence of a conflict with concluded tax treaties. The question was, on the basis of positions taken in literature, whether cases of legitimate tax treaty override could be accepted in order to avoid treaty abuse.

In fact, this is the position of many OECD member states which apply domestic anti-abuse legislation even in case of conflict with existing tax treaties<sup>147</sup>.

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<sup>147</sup> As already pointed out above in the present chapter, this position is mentioned in par. 9.2 of the OECD Commentary to art. 1. Many OECD member countries qualify abuse of treaty according to their domestic anti-abuse provisions and consequently apply

However, an analysis of the OECD position, as mostly expressed within the relevant Commentaries, has immediately showed that the relationship between domestic anti-abuse provisions and treaty provisions is not actually dealt with in terms of justification rather than on the basis of the absence of any conflict between national and international law. According to paragraph 22.1 of the OECD Commentary on art. 1, '[s]uch rules [mostly "substance-over-form", "economic substance" and general anti-abuse rules] are part of the basic domestic rules set by domestic tax laws for determining **which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict ... [emphasis added]**'

The analysis conducted at the beginning of this chapter has led to confute the correctness of the OECD position. The complex interpretative process concerning the individuation of a case of treaty abuse does not merely concern the determination of the facts that give rise to tax liability. Moreover, since tax treaty provisions, as emphasized many times, have the function of limiting taxation as imposed under domestic law, they contribute to determine tax liability exactly to the extent that they exclude or limit taxation. Given this premise, treaty provisions inevitably become parameters of legitimacy in order to establish whether a case of abuse occurred.

The following analysis more specifically regarding CFC legislation has concretely demonstrated that the OECD distributive rules regulate also tax liability.

This chapter has confuted the basic statement on which the OECD position is founded, i.e. that CFC legislation does not affect tax treaties. It has been showed, with the supporting view of prominent scholars, that – in fact – tax treaties distributive rules contain '**additional requirements [Vogel's emphasis] for establishing tax liability, aside from those of domestic law.**'<sup>148</sup> Gutmann, Danon and Salome stated clearly that distributive rules attribute a taxable object to a taxable subject. This also happens with art. 7(1) of OECD Model Convention through the sentence 'profits of an enterprise'<sup>149</sup>.

Article 7(1) establishes that the profits of a corporation can be taxed only in the hands of that corporation and only by its state of residence. Not only art. 7(1) establishes the attribution of a specific taxable object to a specific taxable subject but it also establishes this relationship in an exclusive way. This means that it cannot be accepted the position according to which the state that applies CFC legislation has the sovereign power to attribute a taxable object to a taxable

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domestic legislation even in case of conflict with existing tax treaties. The reasoning underlying this approach is that abuse of treaties causes a loss of income for the state and, therefore, treaty abuse results in an abuse of domestic law.

<sup>148</sup> Vogel, K. et al., *Klaus Vogel On Double Taxation Conventions*, Kluwer Law International, Third Edition, 1997, p. 31.

<sup>149</sup> Gutmann, D., Danon, J. R. and Salome H., *French – Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law*, in *Intertax*, Vol. 31 (2003), No. 4, p. 158.

subject at the same time with the state of residence of the CFC because there are at issue two autonomous sovereign rights.

The exclusive attribution established by art. 7(1) limits the taxing power of the state that wants to apply CFC legislation. The consequence is that a conflict between CFC legislation and art. 7(1) is possible. Thus, when CFC legislation which does not comply with art. 7(1) is introduced after the conclusion of a tax treaty based on the OECD Model Convention, a tax treaty override occurs. The same reasoning is appropriate with regard to art. 10(5) of the OECD Model Convention. This provision is relevant when CFC legislation is based on a deemed distribution of the profits realized by a foreign corporation qualified as a CFC. Also in this case it is not possible to maintain that there is no conflict with the OECD Model Convention. Even if it is accepted that art. 10(5) does not deal with CFC legislation because it only concerns taxation in the state of source of foreign corporations (with exclusion of their shareholders), the notion of deemed dividends is not included within the scope of art. 10. This consequence derives from the use of the term 'paid' which, according to the OECD Commentaries, involves a real disposal on the basis of a transfer of funds. Art. 10 of the OECD Model Convention covers only real distribution of dividends. Thus, CFC legislation which is based on a deemed distribution of dividends is in conflict with art. 10 and a tax treaty override will occur every time such a CFC legislation is introduced after the conclusion of a tax treaty based on the OECD Model Convention.

The OECD Model Convention contains a catch all provision. It is art. 21 whose first paragraph establishes: *'[i]tems of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.'*

It is accepted that art. 21 also includes fictitious income which does not refer to a real economic value<sup>150</sup>. However, it needs to be emphasized that the OECD Model Convention was not drafted with the intention to include fictitious income. From my point of view, its inclusion within the scope of tax treaties leads to a serious incongruence regarding the ability to pay principle. Nevertheless, this principle is mentioned only in the OECD Commentaries and exclusively with reference to art. 18 of the OECD Model Convention to justify taxation of pensions in the state of residence of the recipient. Its application at international level is doubtful, although there are scholars that support this possibility<sup>151</sup>.

Even if it is accepted that CFC legislation which is based on a deemed distribution of income is included within the scope of art. 21 of the OECD Model Convention, this does not imply that tax treaty override is not possible. In this case the outcomes of the analysis conducted in the previous chapter are

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<sup>150</sup> See for example Wattel, P. J. and Marres, O., *Characterization of Fictitious Income under OECD-Patterned Tax Treaties*, in *European Taxation*, Vol. 43 (2003), No. 3, pp. 69 – 70.

<sup>151</sup> See for example Schön, W., *International Tax Coordination for a Second-Best World (Part I)*, in *World Tax Journal*, (2009), Vol. 1, No 1, pp. 71 – 73.

relevant. Tax treaty override will occur every time amended domestic law will determine a shift in the application of the relevant distributive rule and this shift will cause a unilateral extension of the taxing power of the amending state. Since CFC legislation based on an ‘entity approach’ actually aims at taxing the undistributed profits of a foreign corporation qualified as CFC, art. 7 should apply on the basis of the very nature of the taxable income. When art. 21 is instead applied an illegitimate extension of the taxing power of the amending state takes place and a case of tax treaty override occurs.

To conclude on this point, the analysis concerning CFC legislation does not allow to agree with the OECD that tax treaties are not affected by such legislation. It has been demonstrated that the OECD Model Convention, through its distributive rules, governs aspects concerning tax liability and the relationship between taxable income and taxable subject is not left exclusively to the contracting states’ sovereignty. On the contrary, their sovereignty is limited and this limitation causes conflicts between CFC legislation and treaty provisions. These conflicts are, indeed, at the origin of possible cases of tax treaty override in the different situations described above.

A few more comments need to be added about the interpretative approach of the OECD with respect to the Model Convention. The analysis concerning the relationship between CFC legislation (and in general domestic anti-abuse rules) is particularly difficult not only because, as already emphasized above in this chapter, the OECD has not developed yet an anti-abuse doctrine, but mostly because it obstinately wants to apply a Model Convention which was conceived and structured to avoid double taxation and not to curb tax avoidance and evasion. Rixen has even attributed to the OECD the tendency to develop ‘*creative interpretation*’ of existing international tax rules to permit the implementation of unilateral measures against double non-taxation’.<sup>152</sup>

Furthermore, the OECD severely maintains its position according to which CFC legislation does not affect tax treaty provisions. However, in this way the OECD bases on a strictly formal interpretative approach (the sharp separation between CFC legislation and tax treaty provisions) a regulation that, exactly because of its anti-abuse nature, has a substantive aim, i.e. taxing profits of a foreign company that enjoys tax privileges.

As emphasized by Rixen, in fact, while the fundamental principle of separation of entities is substantially breached in a system still based on a jurisdictional delimitation, the OECD interpretative position reinforces the formal structure of the Model. The approach according to which the attribution of a taxable income to a taxable subject is reserved to each contracting state is – in the end

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<sup>152</sup> Rixen, T., *The Political Economy of International Tax Governance*, Transformations of State Series, Palgrave MacMillan, 2008, pp. 125 – 126 (and relevant quotations).

– a strong reaffirmation of the ‘principle of legislative tax sovereignty’<sup>153 154</sup>. The contradiction is striking.

The OECD member countries are divided and the conflict is certainly not easy to solve. Nevertheless, the solution cannot stem from a Model Convention which has not the characteristics to reach a coherent solution. Furthermore, it is clear that, given the conflicts between the OECD member states, the OECD Commentary cannot be considered as expression of the intentions of the parties in a contextual interpretation. Indeed, renegotiation of tax treaties requires time, but, given the circumstances, the introduction of anti-abuse provisions (at least in new tax treaties) appears the only solution that would legitimately protect the will of both contracting parties and avoid tax treaty override in case of a subsequent introduction of CFC legislation.

Emblematic what Gutmann, Danon and Salome wrote when commenting the Schneider case: *‘[t]he only certainty in the end is that the taxation in France of the subsidiary’s profit takes place by virtue of an unilateral act of sovereignty of the French state ...’*<sup>155</sup>. This unilateral act of sovereignty can be avoided, as emphasized by the Conseil d’Etat, only when both parties agree about the application of anti-abuse provisions.

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<sup>153</sup> Rixen, T., *The Political Economy of International Tax Governance*, Transformations of State Series, Palgrave MacMillan, 2008, pp. 26 – 29.

<sup>154</sup> See Rixen, T., *The Political Economy of International Tax Governance*, Transformations of State Series, Palgrave MacMillan, 2008, p. 125.

<sup>155</sup> Gutmann, D., Danon, J. R. and Salome H., *French – Swiss Point of View on the Société Schneider Electric Case: Some Thoughts on the Personal Attribution of Income Requirement in International Tax Law*, in Intertax, Vol. 31 (2003), No. 4, p. 162.





## Chapter VI

### *Application of the ‘interpretative model’*

#### **1.Introduction: the developed ‘interpretative model’**

The analysis conducted in the previous chapters has had the main purpose of exploring all the possible relevant aspects characterizing cases of tax treaty override. The following interpretative model has been consequently developed:

1. The rightly applicable distributive rule needs to be individuated. The individuation of the rightly applicable distributive rule needs to be based on the qualification of the relevant item of income or capital by virtue of its very nature, i.e. its source;
2. The exact relationship between the constituent elements of the relevant distributive rule and domestic law needs to be evaluated. Vogel’s model of distributive rule can be used for this purpose. It is necessary to establish to what extent state sovereignty has been limited, i.e. to what extent the possibility to apply domestic law has been limited. The exact relationship between the domestic taxing provisions and the treaty relieving provisions needs to be established;
3. If the rightly applicable distributive rule uses terms which are not defined within the text of the relevant treaty art. 3(2) of the OECD Model Convention mandatorily applies. The state that applies the treaty uses the domestic definition applied within the state of source<sup>1</sup>. The domestic definition is used as existing at the moment the treaty is applied unless the context otherwise requires. Precedence is given to a domestic investigation about the correspondent domestic definition even if it has been modified after the conclusion of the relevant tax treaty (ambulatory interpretation). Only if the treaty context requires otherwise, which also means that the context can clearly be considered the expression of the common intention of the parties, a contextual definition will apply. The treaty context could also limit the possibility of an ambulatory interpretation and requires the application of a term as defined under domestic law at the moment of the conclusion of the relevant treaty. Treaty context and domestic law can also be mutually applied. When the treaty context does not contain an exhaustive definition but only elements that delimit the domestic definition,

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<sup>1</sup> For the exceptional cases when this rule does not apply, see *infra* chapter IV, footnote No. 29.

this domestic definition will be applied within the limits established by the context. The OECD Commentaries are also included within the notion of context. It is, however, necessary to prove that in the concrete case at issue they actually express the common intention of the contracting states. The applicable OECD Commentaries are those existing at the moment of the conclusion of the relevant treaty. Art. 3(2) also admits fictitious definitions to the extent that they are compatible with the wording and context of the relevant distributive rule. In general, the use of the terms ‘derived’ and ‘paid to’ excludes the possibility to use fictitious qualifications of items of income and capital (in the following simulations this part of the interpretative model will be reported only to the extent needed);

4. When the relevant item of income or capital is domestically qualified on the basis of fictions or lump-sum applies, the compliance of this fictitious qualification or the use of lump-sum needs to be evaluated on the light of the previous (see point No.1) qualification based on the very nature of the item of income or capital at issue on the basis of its real source;
5. In particular, an amendment subsequent to the conclusion of the relevant tax treaty cannot recharacterize items of income and capital or introduce the payment of lump-sum that determine a shift in the taxing power of the contracting states. This amendment is illegitimate when it determines the application of a distributive rule favourable to the amending contracting state but which is not the distributive rule rightly applicable on the basis of the qualification of the relevant item of income or capital on the basis of its very nature. In this case a tax treaty override occurs;
6. Fictions regarding the residence of taxpayers cannot completely lack a nexus with the state claiming taxing rights. When a provision concerning fictitious residence is introduced after the conclusion of the relevant tax treaty and it is not based on any concrete nexus with the state claiming taxing rights, there is an illegitimate attribution of taxing power that determines a case of tax treaty override;
7. More in general, tax treaty override occurs whenever an amendment subsequent to the conclusion of a tax treaty extends the taxing power of the amending contracting state beyond the limits established by the relevant distributive rule so that domestic taxing legislation becomes wider than the treaty relieving provisions;
8. A tax treaty override is furthermore realized when domestic legislation which has been unilaterally introduced after the conclusion of a tax treaty has the actual purpose of preventing the application of the treaty;

9. Saving clauses can be introduced in the specific tax treaty;
10. Anti-abuse clauses can be introduced in the specific tax treaty;
11. When more than one interpretation is possible, priority needs to be given to the interpretation that conciliates the application of both domestic law and treaty provisions.

In this chapter the developed interpretative model will be applied in order to verify whether cases of tax treaty override have actually been realized.

First of all, the recently introduced U.S. exit tax regime is tested. It has substituted the unsuccessful expatriation tax. The 'genuine' U.S. exit tax regime reflects the most common features of this kind of legislation. A deemed alienation has been introduced in order to guarantee taxation in the state of source. However, the application of the expatriation tax for many years had led the United States to introduce in the tax treaties a saving clause aimed at preserving taxation of previous citizens and long-term residents. This is possibly a solution to guarantee the application of exit tax regimes under the OECD Model Convention.

Afterwards, the peculiar UK 're- entry charge' will be tested. This regime is founded on a fiction according to which tax liability on capital gains realized abroad arises only in the year of return of the taxpayer to the UK.

Finally, the CFC transactional method will be applied. The transactional method is peculiar because it covers only specific items of income – mostly passive income.

This chapter has mainly a practical purpose. However, it will also give us the opportunity to further reflect upon tax treaty override through the analysis and the comments concerning the specifically tested regimes.

## **2. The long-lasting U.S. expatriation regime and the new exit tax: recurring cases of tax treaty override in the United States**

The U.S. expatriation tax was firstly introduced in 1966 with the Foreign Investors Tax Act (FITA). The purpose was clearly to prevent tax avoidance.

Section 877 (a) of the Internal Revenue Code established a regime based on taxation of U.S.- source income in the hands of citizens who left the U.S., for a period of 10 years following the year of expatriation. It stated exactly: *'Every nonresident alien individual who at any time after March 8, 1965, and within the 10-year period immediately preceding the close of the taxable year lost United States citizenship, unless such loss did not have for one of its principal purposes the avoidance of taxes under this subtitle or subtitle B, shall be taxable for such taxable year in the manner provided in subsection (b) if the tax imposed pursuant to such subsection exceeds the tax which, without regard to this section is imposed pursuant to section 871'.*

The Health Insurance Portability and Accountability Act of 1996 explains the scope of the mentioned provision as follows: ‘*An individual who relinquishes his U.S. citizenship with a principal purpose of avoiding U.S. taxes is subject to tax on his or her U.S. source income at the rates applicable to U.S. citizens, rather than the rates applicable to other non-resident aliens, for 10 years after expatriation. In addition, the scope of items treated as U.S. source income for this purpose is broader than those items generally considered to be U.S. source income. For example, gains on the sale of personal property located in the United States and gains on the sale or exchange of stock or securities issued by U.S. persons are treated as U.S. source income.*’<sup>2</sup>

The taxpayer had the possibility to prevent the application of the expatriation regime when he or she would succeed in excluding that one of its principal purpose was tax avoidance.

‘*Determination regarding a taxpayer’s principal motive for expatriating only required the Secretary of the Treasury ... to establish that it was reasonable to believe that, but for this Section, the taxpayer would receive a significant tax benefit. The burden then shifted to the taxpayer to prove that his or her motive was not tax-avoidance despite the significant tax benefits gained through expatriation. If the expatriate failed, the former citizen was taxed for the ten year period following formal expatriation.*’<sup>3</sup>

In 1996 the regime at issue was significantly amended<sup>4</sup>, with retrospective effect<sup>5</sup>.

First of all, an objective presumption of tax avoidance was introduced for individuals who exceeded a certain tax liability or net wealth level<sup>6</sup>. When this

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<sup>2</sup> House of Representatives, Health Insurance Portability and Accountability Act of 1996, Conference Report No. 104 736, p. 323.

<sup>3</sup> Agnew, C. L., *Expatriation, Double Taxation, and Treaty Override: Who Is Eating Crow Now*?, in The University of Miami Inter-American Law Review, Vol. 28 (1996), No. 1, pp. 75 –76.

<sup>4</sup> The expatriation regime was amended by the Clinton Administration through the Health Insurance Portability and Accountability Act of 1996, Public Law No. 104 – 191, sections 511 – 512 ( that amended section 877 of the Internal Revenue Code) to finance the reform.

<sup>5</sup> Health Insurance Portability and Accountability Act of 1996, Public Law No. 104 – 191, sections 511 (g) and 512 (c).

<sup>6</sup> Infanti, A. C., *United States*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 374; Vacovec, K. J. and Beutler T. M., *United States*, in *The tax treatment of transfer of residence by individuals*, Cahiers de droit fiscal international, Volume LXXXVIIb, IFA 2002 Oslo Congress, Kluwer Law International, 2002, pp. 602, 607; Agnew, C. L., *Expatriation, Double Taxation, and Treaty Override: Who Is Eating Crow Now*?, in The University of Miami Inter-American Law Review, Vol. 28 (1996), No. 1, p. 78.

‘wealth test’<sup>7</sup> was satisfied the expatriation regime would apply regardless of the real motive of the transfer<sup>8</sup>.

Only certain categories of taxpayers could apply for a ruling in order to ascertain the absence of a tax avoidance purpose<sup>9</sup>.

The second important amendment introduced in 1996 concerned the inclusion within the scope of the expatriation regime of long-term residents (in addition to citizens). ‘*For purposes of Section 877, long-term permanent residents are those individuals who lawfully reside as a permanent resident in the United States for eight of the fifteen years preceding expatriation.*’<sup>10</sup>

Finally – and most importantly – the 1996 regime extended the tax liability of those subjects falling within the scope of the expatriation tax. Some items of income and capital were assumed to be U.S. sourced under section 877 (d) of the Internal Revenue Code. It is worth noting that taxation was also extended to include gains and income derived from a controlled foreign corporation under certain conditions.<sup>11</sup>

Thus, according to section 877 (a) of the Internal Revenue Code, as amended in 1996, U.S. citizens and/or long-term residents who left the U.S. were taxed for the 10 years following the year of expatriation on U.S. sourced items of income and capital as re-characterized under section 877 (d).

This 1996 regime raised many problems of compliance with existing tax treaties. The U.S. tax treaty Model traditionally contains a saving clause that allows the application of the expatriation regime because it excludes the applicability of the treaty to some categories of individuals. Nevertheless, tax treaties in force before 1996 did not mention former residents (but only current citizens and/or former citizens – depending on the specific tax treaty). The 1996 expatriation regime was, therefore, in conflict with existing tax treaties because it extended the U.S. tax jurisdiction beyond the limits set by the saving clause (i.e. to former residents).

At that time the legislative situation was quite confusing. From the legislative history it could be inferred the intention of the legislator in 1966 to override existing treaty provisions that were in conflict with the amended regime. However, it was also recognized that at the end of a period of 10 years, during which the U.S. would renegotiate conflicting double tax conventions, treaty provisions still in conflict would prevail on the expatriation regime.

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<sup>7</sup> Agnew, C. L., *Expatriation, Double Taxation, and Treaty Override: Who Is Eating Crow Now ?*, in *The University of Miami Inter-American Law Review*, Vol. 28 (1996), No. 1, p. 78.

<sup>8</sup> However some exceptions were established by section 877 (c) of the Internal Revenue Code.

<sup>9</sup> Agnew, C. L., *Expatriation, Double Taxation, and Treaty Override: Who Is Eating Crow Now ?*, in *The University of Miami Inter-American Law Review*, Vol. 28 (1996), No. 1, p. 79.

<sup>10</sup> Agnew, C. L., *Expatriation, Double Taxation, and Treaty Override: Who Is Eating Crow Now ?*, in *The University of Miami Inter-American Law Review*, Vol. 28 (1996), No. 1, p. 80.

<sup>11</sup> See section 877 (d) (1) (C) of the Internal Revenue Code.

The Congress stated: ‘While it is believed that the expatriation tax provisions, as amended by the House bill, are generally consistent with the underlying principles of income tax treaties to the extent the House of bill provides a foreign tax credit for items taxed by another country, **it is intended that the purpose of the expatriation tax provisions as amended, not be defeated by any treaty provision [emphasis added]**. The Treasury Department is expected to review all outstanding treaties to determine whether the expatriation tax provisions, as revised, potentially conflict with treaty provisions and to eliminate any such potential conflicts through renegotiation of the effected treaties as necessary. **Beginning on the tenth anniversary of the enactment of the House bill, any conflicting treaty provisions that remain in force would take precedence over the expatriation tax provisions as ruled [emphasis added]**’<sup>12</sup>

It is worth noting that section 110 of the 1966 Foreign Investor Act, which, as already said, introduced the first expatriation regime, stated clearly that ‘[n]o amendment made by this article shall apply in any case where its application would be contrary to any treaty obligation of the United States.’

As a consequence of this statement, in the 1985 case *Crow v. Commissioner*<sup>13</sup> the U.S. Supreme Court excluded that the domestic regime could prevail on the then applicable tax treaty concluded between the United States and Canada. The Supreme Court excluded the possibility that the United States could tax capital gains realized by an individual that after the transfer had become a citizen of Canada. The reason was that the saving clause which was included in the treaty only mentioned current citizens and not also former citizens of the United States<sup>14</sup>.

The evolution of the U.S. approach to international treaties follows – also with reference to the expatriation regime – the pattern described in the second chapter of the present study. Also with the expatriation regime there is a gradually development toward unilateralism. The amendments of the expatriation regime are accompanied by a gradually firmer attitude to override tax treaties.

The scope of the saving clause was expanded in the years. However, in 1996 not all tax treaties concluded by the United States contained a saving clause mentioning previous citizens and no treaty at all mentioned former long-term residents: ‘Tax treaties concluded after 1981 generally contained provisions that would permit the United States to tax its former citizens who expatriated to avoid taxes ... Moreover, none of the pre-1997 treaties permitted the United States to tax its former long-term residents who expatriated ...’.<sup>15</sup>

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<sup>12</sup> House of Representatives, Health Insurance Portability and Accountability Act of 1996, Conference Report No. 104 736, p. 329

<sup>13</sup> 85 TC 376 (1985).

<sup>14</sup> Agnew highlights that the applicable tax treaty included a so-called ‘Class I’ saving clause provisions.

<sup>15</sup> Infanti, A. C., *United States*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 374.

Notwithstanding the intention of the Congress to renegotiate conflicting tax treaties, the later in time rule applied and – in the end – the 1996 expatriation regime prevailed on conflicting tax treaties<sup>16</sup>.

The U.S. saving clause offers an interesting perspective to evaluate the compliance of exit taxation with tax treaties. It should be recalled that the U.S. Tax Treaty Model Convention substantially corresponds to the OECD Model Convention. Indeed, the scope of the saving clause is to extend both contracting states jurisdiction in case of emigration since, according to the U.S. Model Convention – exactly as in the OECD Model Convention – capital gains are in principle taxable only in the alienator's state of residence<sup>17</sup>.

The U.S. Model Convention, just as the OECD Model Convention, has not been conceived to cover taxation upon emigration. The introduction of a saving clause in principle conciliate exit tax with double tax conventions since it is based on a reciprocally agreed extension of tax jurisdiction. Taxation of previous citizens or residents is not in conflict with tax treaties to the extent that double taxation is avoid.

The latest version of the saving clause is contained in art. 1(5) of the 2006 U.S. Model Convention. It reads: *'Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens.'*

*Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, for the period of ten years following the loss of such status be taxed in accordance with the laws of that Contracting State'.*

This formula, with some amendments, could really represent a starting point to elaborate a treaty provision that guarantees taxation of capital gains in the state where they accrued. Indeed, particular attention needs to be paid to the domestic law of the other contracting state and, above all, to possible re-characterization of income as source income (just like happened in the United States with the expatriation regime).

## 2.1 The new U.S. exit tax regime

In 2008 the United States introduced a 'genuine' exit tax regime based on a mark to market principle. After a many years debate the U.S. decided to gradually<sup>18</sup>

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<sup>16</sup> Infanti, A. C., *United States*, in Maisto, G. (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, pp. 374 – 375. See also Vacovec, K. J. and Beutler T. M., *United States*, in *The tax treatment of transfer of residence by individuals*, Cahiers de droit fiscal international, Volume LXXXVIIIb, IFA 2002 Oslo Congress, Kluwer Law International, 2002, p. 609.

<sup>17</sup> See art. 13(6) of the United States Model Income Tax Convention of November 15, 2006: *'Gains from the alienation of any property other than property referred to in paragraphs 1 through 5 shall be taxable only in the Contracting State of which the alienator is a resident.'*

<sup>18</sup> About the different regimes applicable depending on the date of transfer see the U.S. Internal Revenue Service's website at <http://www.irs.gov/Individuals/>



abandon the expatriation tax regime (which was unsuccessful) to introduce a system that is meant to grant a quicker way to collect taxes in case of emigration. Article 877A of the Internal Revenue Code establishes that all the property of a US citizen or long-term resident<sup>19</sup> is deemed to have been sold immediately before expatriation at its fair market value. Section 877A (a)(1) literally states ‘[a] ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value.’

The tax must be paid within ninety days from the lost of the U.S. citizenship or long-term residence.

## 2.2 Application of the interpretative model to the U.S. exit tax regime

The following analysis will apply the developed interpretative model to the new U.S. exit tax regime. We will take into consideration the double tax convention concluded between the Netherlands and the United States in 1992 (only partially amended in 2004) and, therefore, before the new regime was introduced in the United States.

The first consideration that needs to be done is that the treaty between the Netherlands and the U.S. does not include a saving clause.

Furthermore, the treaty at issue follows the OECD Model Convention which is, therefore, a point of reference in the following analysis (instead of the U.S. Model).

Given these premises, we can start to apply the developed interpretative model step by step:

**1. The rightly applicable distributive rule needs to be individuated. The individuation of the rightly applicable distributive rule needs to be based on the qualification of the relevant item of income or capital by virtue of its very nature, i.e. its source.**

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### International-Taxpayers/Expatriation-Tax

<sup>19</sup> See Internal Revenue Code, section 877 (e) (2):

#### *(2) Long-term resident*

*For purposes of this subsection, the term “long-term resident” means any individual (other than a citizen of the United States) who is a lawful permanent resident of the United States in at least 8 taxable years during the period of 15 taxable years ending with the taxable year during which the event described in subparagraph (A) or (B) of paragraph (1) occurs [termination of residency]. For purposes of the preceding sentence, an individual shall not be treated as a lawful permanent resident for any taxable year if such individual is treated as a resident of a foreign country for the taxable year under the provisions of a tax treaty between the United States and the foreign country and does not waive the benefits of such treaty applicable to residents of the foreign country.*

The peculiarity of the U.S. exit tax regime is that it includes all property of the emigrant taxpayer at the moment of the transfer, including also personal properties. This requires to identify all the relevant distributive rules on the basis of the properties owned in the specific case. We take into consideration shareholding and, therefore, taxation of capital gains so that the following analysis can – in fact – be extended also to other countries that use the common exit tax regime.

The U.S. exit tax regime is not based on re-characterization of income or capital. Capital gains are at issue in the present simulation and, therefore, art. 14(7) of the treaty at issue is applicable. According to this provision: *‘Gains from the alienation of any property other than property referred to in paragraphs 1 through 5 shall be taxable only in the State in which the alienator is a resident.’*

**2. The exact relationship between the constituent elements of the relevant distributive rule and domestic law needs to be evaluated. Vogel’s model of distributive rule can be used for this purpose. It is necessary to establish to what extent state sovereignty has been limited, i.e. to what extent the possibility to apply domestic law has been limited. The exact relationship between the domestic taxing provisions and the treaty relieving provisions needs to be established.**

## II Substantive requirements

1. Designation of the particular object under internal tax law to which the rule will apply (the ‘*Objekttatbestand*’ such as ‘income’, ‘profit’, ‘capital’, etc.)  
**> capital gains**
2. Designation of the particular requirements under which the distributive rule will apply (the ‘*Metatattbestand*’):
  - a) Designation of certain characteristics of the tax object that give rise to tax liability: the ‘source’ (‘income from immovable property’, ‘profits of an enterprise’) **> Gains from the alienation of any property, other than that referred to in paragraphs 1, 2, 3, 4 and 5.**
  - b) Designation of certain characteristics of the tax object that determine how the **amount** of tax liability is measured (Swiss literature refers to this as ‘tax separation’ (*Steuerausscheidung*), i.e. exclusion from taxation of certain items of income **> no references**
3. Connection between the *Metatattbestand* and the taxpayer: ‘attribution of tax object’ (‘income derived by a resident’) **> income derived by a resident / residence of the alienator**
4. Connection between the *Metatattbestand* and the taxing State(s): ‘connecting factor’ either
  - a) by a characteristic of the taxpayer (residence, citizenship) **> residence**  
     or
  - b) by characteristics of the transaction or event (e.g. the situs of immovable property)

In the specific simulation at issue the U.S. exit tax regime applies to **capital gains** accrued on shareholding (and, therefore, **property other than that referred to in paragraphs 1, 2, 3, 4 and 5**). The regime at issue covers **income derived by a resident, and specifically by a resident alienator**.

Nevertheless, taxation is based on a fiction. Section 877A (a)(1) of the Internal Revenue Code establishes ‘*[a]ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value.*’

This implies that the exit tax is applied on accrued but not yet realized capital gains. The taxable amount is computed on a fair market basis. However, the relevant sum is not at the disposal of the taxpayer at the moment of emigration. Can art. 14(7) of the treaty concluded between the U.S. and the Netherlands be applied to capital gains not actually realized upon transfer ?

It is important to specify that no preserving assessment is applicable. The taxable amount must be paid within ninety days after renouncing the U.S. citizenship or long-term residence.

**3. If the rightly applicable distributive rule uses terms which are not defined within the text of the relevant treaty art. 3(2) of the OECD Model Convention mandatorily applies. The state that applies the treaty uses the domestic definition applied within the state of source. The domestic definition is used as existing at the moment the treaty is applied unless the context otherwise requires. Precedence is given to a domestic investigation about the correspondent domestic definition even if it has been modified after the conclusion of the relevant tax treaty (ambulatory interpretation). Only if the treaty context requires otherwise, which also means that the context can clearly be considered the expression of the common intention of the parties, a contextual definition will apply. The OECD Commentaries are also included within the notion of context. It is, however, necessary to prove that in the concrete case at issue they actually express the common intention of the contracting states. The applicable OECD Commentaries are those existing at the moment of the conclusion of the relevant treaty. Art. 3(2) also admits fictitious definitions to the extent that they are compatible with the wording and context of the relevant distributive rule.**

In order to establish whether art. 14(7) can apply to accrued but not yet realized capital gains the term ‘alienation’ needs to be interpreted. Only if ‘alienation’ can be interpreted so that it includes ‘deemed alienation’ as well the U.S. exit tax regime can be considered compliant with the tax treaty at issue.

The term alienation is not defined within the treaty text. Therefore, art. 3(2) of the treaty, correspondent to art. 3(2) of the OECD Model Convention, must

apply. The state that applies the tax treaty must follow the definition used by the state of source, unless the context otherwise requires.

The treaty between the United States and the Netherlands entered into force as from the 31<sup>st</sup> of December 1993. According to the position taken in this study, the OECD Commentaries current at the moment of the conclusion of the relevant treaty are considered applicable. The 1992 version of the OECD Commentaries is therefore relevant. Paragraphs 8 and 9 of the Commentary to art. 13 of the Model (correspondent to art. 14 of the treaty between the United States and the Netherlands) are the relevant paragraphs for our purposes. They are actually unchanged in the present Commentary. Paragraph 8 of the OECD Commentary to art. 13 states: *'Special circumstances may lead to the taxation of the capital appreciation of an asset that has not been alienated. This may be the case if the value of a capital asset has increased in such a manner that the owner proceeds to the revaluation of this asset in his books. Such revaluation of assets in the books may also occur in the case of a depreciation of the national currency. A number of States levy special taxes on such book profits, amounts put into reserve, an increase in the paid-up capital and other revaluations resulting from the adjustment of the book-value to the intrinsic value of a capital asset. These taxes on capital appreciation (increment taxes) are covered by the Convention according to Article 2.'*

Paragraph 9 continues: *'Where capital appreciation and revaluation of business assets are taxed, the same principle should, as a rule, apply as in the case of the alienation of such assets. It has not been found necessary to mention such cases expressly in the Article or to lay down special rules. The provisions of the Article as well as those of Articles 6, 7 and 21, seem to be sufficient. As a rule, the right to tax is conferred by the above-mentioned provisions on the State of which the alienator is a resident, except that in the cases of immovable property or of movable property forming part of the business property of a permanent establishment or pertaining to a fixed base, the prior right to tax belongs to the State where such property is situated. Special attention must be drawn, however, to the cases dealt with in paragraphs 13 to 17 below.'*

In chapter four of the present work it has been emphasized that the word 'requires' used in the text of art. 3(2) – 'unless the context otherwise requires' – denotes a certain strength and only when the commentary can be interpreted so that it clearly expresses the common intention of the parties its definitions can be used instead of the domestic ones. In my opinion this is not the case. From the OECD Commentary it cannot be inferred an high probability that the parties wanted to include cases of deemed alienation within the scope of the provision at issue. The Commentary to art. 13 mostly refer to revaluation in the balance sheet made by the owner of the assets and consequently taxed. The Commentary does not refer to cases when the revaluation is imposed by the state.

In my opinion this is not a case when the context requires otherwise. Domestic definitions, therefore, should apply. Curiously, in this case both states adopt a concept of deemed alienation for tax purposes.

As pointed out when commenting the Dutch case law about exit tax on substantial shareholders, art. 4.16 (1) (h) of the Dutch Income Tax Act establishes that ‘alienation’ amounts to the status of being no longer a resident taxpayer. In addition, art. 4.46 of the Dutch Income Tax Act specifies that in case of alienation – as meant in art. 4.16 (1) (h) – the moment of realization is considered to be the moment that is immediately preceding the moment of no longer being a resident taxpayer. The fact that these definitions were introduced only in 2001 is not an obstacle to their application since an ambulatory interpretation is possible. As already pointed out many times Section 877A (a)(1) of the Internal Revenue Code establishes *‘[a]ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value.’* Also in this case an ambulatory interpretation is possible.

The compliance of a deemed alienation with the treaty at issue needs, however, to be evaluated.

**4. When the relevant item of income or capital is domestically qualified on the basis of fictions or lump-sum applies, the compliance of this fictitious qualification or the use of lump-sum needs to be evaluated on the light of the previous (see point No.1) qualification based on the very nature of the item of income or capital at issue on the basis of its real source.**

As already specified above, the U.S. exit tax regime is not based on a re-characterization of income or capital.

**5. In particular, an amendment subsequent to the conclusion of the relevant tax treaty cannot recharacterize items of income and capital or introduce the payment of lump-sum that determine a shift in the taxing power of the contracting states. This amendment is illegitimate when it determines the application of a distributive rule favourable to the amending contracting state but which is not the distributive rule rightly applicable on the basis of the qualification of the relevant item of income or capital on the basis of its very nature. In this case a tax treaty override occurs.**

The introduction of the exit tax regime has not determined a shift in the taxing power of the contracting states based on a re-characterization of income.

**6. Fictions regarding the residence of taxpayers cannot completely lack a nexus with the state claiming taxing rights. When a provision concerning fictitious residence is introduced after the conclusion of the relevant tax treaty and it is not based on any concrete nexus with the state claiming taxing rights, there is an illegitimate attribution of taxing power that determines a case of tax treaty override.**

The fiction introduced through Section 877A (a)(1) of the Internal Revenue Code and according to which properties are deemed to be alienated just a day

before the lost of the U.S. citizenship or long-term residence, in fact, not only concerns deemed alienation but, at the same time, implies that the taxpayer is no longer citizen or long-term resident of the United States. An exit tax is legitimately (at least from a domestic point of view) applied only on the basis of a transfer of tax residence (or citizenship) that excludes the unlimited (worldwide) taxing power of the state of departure. Therefore, the fiction according to which all property is deemed to be alienated a day before emigration can be applied only if the taxpayer has, in fact, transferred its citizenship or long-term residence. Accordingly, the U.S. exit tax regime applies to both U.S. citizens who expatriate and long-term U.S. permanent residents who renounce to their green card. The consequence is an immediate taxation (within ninety days from the lost of the U.S. citizenship or long-term residence).

Since the exit tax applies when the citizens or long-term residents are already resident in the other contracting state, section 877A (a)(1) of the Internal Revenue Code actually attributes to the United States a taxing right which is already of the state of destination (exactly because the U.S. exit tax regime applies when the taxpayer is already actually resident in the other contracting state). Thus, the exit tax regime at issue determines an illegitimate attribution of taxing power that according to art. 14(7) of the treaty between the United States and the Netherlands is 'only' of the state where the taxpayer is resident.

The new U.S. exit tax regime has, therefore, realized a case of tax treaty override because it is based on an illegitimate attribution of taxing power determined by the use of a provision which implies fictitious residence in the U.S.

**7. More in general, tax treaty override occurs whenever an amendment subsequent to the conclusion of a tax treaty extends the taxing power of the amending contracting state beyond the limits established by the relevant distributive rule so that domestic taxing legislation becomes wider than the treaty relieving provisions.**

This simulation concerns the more specific case described under point six of the model.

8. A tax treaty override is furthermore realized when domestic legislation which has been unilaterally introduced after the conclusion of a tax treaty has the actual purpose of preventing the application of the treaty.

This is another aspect relevant in the present simulation and which commonly characterizes exit tax regimes.

Section 877A (a)(1) of the Internal Revenue Code establishes that *'[a]ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value.'*

In fact, the mentioned provision anticipates taxation so that the application of the relevant tax treaty is avoided. The deeming provision at issue actually prevents the application of the treaty in order to guarantee domestic taxation.

The introduction of Section 877A (a)(1) of the Internal Revenue Code has realized a tax treaty override also in this respect.

### 2.3 *The consequences deriving from the application of the U.S. saving clause*

In this specific simulation two conflicting aspects have been individuated. Essentially, a tax treaty override has been caused by the unilateral introduction of a fiction that actually prevents the application of the relevant tax treaty in order to assure taxation in the state of source. This is exactly the purpose of Section 877A (a)(1) of the Internal Revenue Code according to which *‘[a]ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value.’*

In addition, it has been emphasized that a tax treaty override has been realized because the U.S. exit tax regime, in conflict with art. 14(7) of the treaty between the U.S. and the Netherlands (which corresponds to art. 13(5) of the OECD Model Convention) imposes taxation in the hands of taxpayers that are no longer resident in the U.S. when tax liability arises. In this case the introduction of the U.S. saving clause could have avoided the conflict since it extends the taxing power of the contracting states to previous citizens and long-term residents.

As recalled above, the latest version of the saving clause is contained in art. 1(5) of the 2006 U.S. Model Convention. It reads: *‘Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens.*

*Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, for the period of ten years following the loss of such status be taxed in accordance with the laws of that Contracting State’.*

Such a clause could be considered a starting point to find a solution that could guarantee the taxing rights of the state where income accrued.

It is worth recalling what has been emphasized in the course of the previous analysis concerning the application of the interpretative model to exit taxation. An exit tax can be legitimately applied from a domestic point of view only when the state of origin has actually lost its unlimited taxing power on the emigrant taxpayer. This means that an exit tax normally applies when the taxpayer is already resident in the state of destination. The introduction within tax treaties of a clause similar to the U.S. saving clause could solve this problem by clearly establishing that previously resident taxpayers are liable to tax on income accrued during the previous period of residence in the state of origin.

### 3. The ‘re-entry charge’ in the United Kingdom

The United Kingdom does not apply any tax on capital gains upon emigration of resident individuals. However, quite peculiarly, the Finance Act 1998 by adding section 10A to the Taxation of Chargeable Gains Act (TCGA) 1992 introduced a



‘re-entry charge’<sup>20</sup>. The tax applies to individuals who were resident or ordinarily resident<sup>21</sup> in the U.K. for at least four out of the seven years immediately preceding the transfer and became non-resident and non-ordinarily resident for less than five years. The capital gains realized abroad on assets already owned<sup>22</sup> during the period of residence or ordinary residence in the UK are deemed to be realized only when the taxpayer becomes again resident of the UK. In short, in the UK, the deemed realization of capital gains is not anticipated to the moment immediately preceding the transfer but postponed until the moment the taxpayer comes back to the United Kingdom. This feature clearly shows the anti-avoidance purpose of the regime at issue. When the taxpayer remains abroad for a period short enough to prove that the transfer was only aimed at realizing capital gains abroad, taxation applies at the moment the taxpayer comes back to the United Kingdom.

For this reason, the Court of Justice of the European Union in the *de Lasteyrie* case proposed a ‘re-entry charge’ as a measure proportionate to curb tax avoidance<sup>23</sup>. Indeed, the perspective changes completely from an international point of view. It is, therefore, necessary to verify whether cases of tax treaty override have been possibly realized with the introduction of the re-entry charge in 1998.

It is, however, preliminarily important to point out that the Finance (No 2) Act 2005 explicitly established that the re-entry charge must apply notwithstanding the provisions of existing tax treaties under which taxpayers could claim their status of non-resident in the UK for treaty purposes<sup>24</sup>. The aim was to impede

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<sup>20</sup> See HM Revenues & Customs, Capital Gains Manual: Main Contents, at <http://www.hmrc.gov.uk/manuals/cgmanual/>; Morton, P. and Sykes, L., *United Kingdom*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 809; Marrani, D., *Contribution to the study of “exit tax” in the UK*, in *European Tax Studies*, No. 1/2009 (ste.seast.org/en); Baker, P., *United Kingdom*, in *The tax treatment of transfer of residence by individuals*, Cahiers de droit fiscal international, volume LXXXVIIa, IFA 2002 Oslo Congress, Kluwer Law International, 2002, pp. 559 – 596.

<sup>21</sup> According to Baker, ‘... [t]here is no statutory definition of residence for IT (or CGT) purposes: an individual will be regarded as resident in the UK if he is present for more than 183 days in a year of assessment or for 91 days on average over a four-year period. To a limited extent for IT purposes (but more extensively for CGT purposes) UK legislation also uses the connecting factor of ordinary residence: broadly, an individual is ordinarily resident in the UK if he is resident from year to year.’ See Baker, P., *United Kingdom*, in *The tax treatment of transfer of residence by individuals*, Cahiers de droit fiscal international, volume LXXXVIIa, IFA 2002 Oslo Congress, Kluwer Law International, 2002, pp. 559 – 560.

<sup>22</sup> The legislation at issue also includes some assets acquired during the period of non residence in the UK. See Morton, P. and Sykes, L., *United Kingdom*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 809.

<sup>23</sup> ECJ 11 March 2004, C-9/02 *de Lasteyrie du Saillant* [2004] ECR I-2409, par. 54.

<sup>24</sup> Morton, P. and Sykes, L., *United Kingdom*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010



that taxpayers – exactly by claiming their status of non-resident under a tax treaty at the moment of actual realization – could avoid the re-entry charge.

*3.1 Concrete evaluation of a possible case of tax treaty override on the basis of the double tax convention concluded between Italy and the United Kingdom*

The tax treaty concluded between Italy and the United Kingdom entered into force in 1990 and, therefore, before the introduction of the re-entry charge in the UK in 1998.

**1. The rightly applicable distributive rule needs to be individuated. The individuation of the rightly applicable distributive rule needs to be based on the qualification of the relevant item of income or capital by virtue of its very nature, i.e. its source**

The UK re-entry charge applies generally to capital gains realized by individuals. For this reason, in order to cover the most common as well as the most relevant situation, we assume again that the emigrant taxpayer owns shareholding. Thus, the relevant distributive rule is art. 13(4) of the treaty concluded between Italy and the United Kingdom (correspondent to art. 13(5) of the OECD Model Convention). It is worth noting that the treaty at issue is essentially based on the OECD Model Convention.

The UK re-entry charge is not based on re-characterization. Therefore, there is no need to verify the real nature of income/capital at issue.

**2. The exact relationship between the constituent elements of the relevant distributive rule and domestic law needs to be evaluated. Vogel’s model of distributive rule can be used for this purpose. It is necessary to establish to what extent state sovereignty has been limited, i.e. to what extent the possibility to apply domestic law has been limited. The exact relationship between the domestic taxing provisions and the treaty relieving provisions needs to be established.**

II Substantive requirements

1. Designation of the particular object under internal tax law to which the rule will apply (the ‘*Objekttatbestand*’ such as ‘income’, ‘profit’, ‘capital’, etc.)  
**> capital gains**
2. Designation of the particular requirements under which the distributive rule will apply (the ‘*Metatattbestand*’):
  - a) Designation of certain characteristics of the tax object that give rise to tax liability: the ‘source’ (‘income from immovable property’, ‘profits of an enterprise’) **> Gains from the alienation of any property**,

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Rome Congress, Sdu Uitgevers, 2010, p. 809.

**other than that referred to in the preceding paragraphs of the article.**

- b) Designation of certain characteristics of the tax object that determine how the **amount** of tax liability is measured (Swiss literature refers to this as 'tax separation' (*Steuerabscheidung*), i.e. exclusion from taxation of certain items of income > **no references**
- 3. Connection between the *Metatatsbestand* and the taxpayer: 'attribution of tax object' ('income derived by a resident') > **income derived by a resident / residence of the alienator**
- 4. Connection between the *Metatatsbestand* and the taxing State(s): 'connecting factor' either
  - a) by a characteristic of the taxpayer (residence, citizenship) > **residence**
  - or
  - b) by characteristics of the transaction or event (e.g. the situs of immovable property)

In this simulation the U.K. regime is applied on **capital gains** accrued on shareholding (and, therefore, **property other than that referred to in the preceding paragraphs of the article**). The regime at issue covers **income derived by a resident. However, although the taxpayer is liable to tax in the year of return when he or she is resident of the UK again, capital gains were realized abroad when the taxpayer was not resident of the UK.** According to section 10A of the TCGA 1992 the taxpayer is taxed in the UK as if the capital gains were realized in the UK in the year of return.

The discrepancy with art. Art. 13(4) is immediately evident: '*Gains from the alienation of any property other than that referred to in the preceding paragraphs of this Article shall be taxable only in the Contracting State of which the alienator is a resident*'. Clearly, the treaty provision at issue establishes simultaneity between the status of being a resident of a certain state, the alienation by the same resident in the state of residence, and the right to tax of the same state.

**3.If the rightly applicable distributive rule uses terms which are not defined within the text of the relevant treaty art. 3(2) of the OECD Model Convention mandatorily applies. The state that applies the treaty uses the domestic definition applied within the state of source. A domestic definition is used as existing at the moment the treaty is applied unless the context otherwise requires. Precedence is given to a domestic investigation about the correspondent domestic definition even if it has been modified after the conclusion of the relevant tax treaty (ambulatory interpretation).**

There are two terms not defined within the treaty text. They are 'alienation' and 'capital gains'. Section 10A of the TCGA 1992 does not use fictions relating the concepts of 'alienation' and 'capital gains'. These terms do not rise particular interpretive problems. Capital gains are realized on the basis of a real act of disposal.

**4. When the relevant item of income or capital is domestically qualified on the basis of fictions or lump-sum applies, the compliance of this fictitious qualification or the use of lump-sum needs to be evaluated on the light of the previous (see point No.1) qualification based on the very nature of the item of income or capital at issue on the basis of its real source.**

Section 10A of the TCGA 1992 has not re-characterized the capital gains at issue.

**5. In particular, an amendment subsequent to the conclusion of the relevant tax treaty cannot recharacterize items of income and capital or introduce the payment of lump-sum that determine a shift in the taxing power of the contracting states. This amendment is illegitimate when it determines the application of a distributive rule favourable to the amending contracting state but which is not the distributive rule rightly applicable on the basis of the qualification of the relevant item of income or capital on the basis of its very nature. In this case a tax treaty override occurs.**

Since no re-characterization occurred, indeed, there has not been shift in the taxing power of the contracting states caused by such a re-characterization.

**6. Fictions regarding the residence of taxpayers cannot completely lack a nexus with the state claiming taxing rights. When a provision concerning fictitious residence is introduced after the conclusion of the relevant tax treaty and it is not based on any concrete nexus with the state claiming taxing rights, there is an illegitimate attribution of taxing power that determines a case of tax treaty override.**

The UK regime at issue is not even founded on fictitious residence since the re-entry charge is applied when the taxpayer is again resident in the United Kingdom.

**7. More in general, tax treaty override occurs whenever an amendment subsequent to the conclusion of a tax treaty extends the taxing power of the amending contracting state beyond the limits established by the relevant distributive rule so that domestic taxing legislation becomes wider than the treaty relieving provisions.**

This is exactly the problematic point in the UK legislation at issue. It extends the UK taxing power beyond the limits established by the distributive rule, as resulting from the analysis conducted by using Vogel’s model of distributive rule. As emphasized, art. 13(4) establishes correspondence between the state where capital gains are realized and the state that has the right to tax. The UK legislation at issue – again by virtue of a fiction – attributes the taxing power to the UK while the capital gains are realized abroad during a period when the taxpayer is resident abroad.

**8. A tax treaty override is furthermore realized when domestic legislation which has been unilaterally introduced after the conclusion of a tax treaty has the actual purpose of preventing the application of the treaty.**

As explained in the introduction which has described the regime concerning the UK re-entry charge, in 2005 the UK legislature has introduced a provision according to which the regime at issue shall apply notwithstanding any provision in any treaty in force. The aim was to impede that taxpayers could avoid taxation on capital gains realized abroad by claiming their status of non-resident in the UK under an international tax treaty. In 2005 a legislative tax treaty override has been realized.

**9. Saving clauses can be introduced in the specific tax treaty.**

Art. 13(5) of the tax treaty between Italy and the United Kingdom establishes: *‘The provisions of paragraph (4) of this Article shall not affect the right of a Contracting State to levy according to its law a tax on gains from the alienation of any property derived by an individual who: (a) is a resident of the other Contracting State; and (b) has been a resident of the first-mentioned Contracting State at any time during the five years immediately preceding the alienation of the property; and (c) is not subject to tax on those gains in the other Contracting State’.*

Since Italy does not tax capital gains accrued on shareholding held by individuals, the UK is allowed to apply the re-entry charge under art. 13(5)(c). The introduction of the re-entry charge in 1998 has not override the tax treaty concluded between Italy and the UK.

*3.2 Conclusive remarks on the possibility of a treaty override concerning the UK ‘re-entry charge’*

The application of the developed interpretative model has showed that the UK re-entry charge is in principle non-compliant with the OECD Model Convention. The point is that the United Kingdom taxes individuals at the moment they are resident there but on capital gains realized abroad. Art. 13(5) of the OECD Model Convention establishes taxation of capital gains in the state of residence of the alienator at the moment of alienation. This provision establishes coincidence between the moment when capital gains are realized and the *status* of resident of a contracting state. In short, only the state of residence at the moment of realization is allowed to tax capital gains in the hands of the alienator. The interpretation of the term ‘alienation’ is not at issue. A real act of disposal takes place abroad. The crucial interpretative question is whether this act of disposal can give rise to tax liability in a state different than the state of residence of the alienator at the moment when the disposal became effective.

There are no indications in the text or context of the OECD Model Convention that allow to recognize exceptions to the rule established by art. 13(5). It can only be concluded that if the realization effect took place abroad, the UK is not

allowed to tax<sup>25</sup>. These are the consequences that can be inferred from the OECD Model Convention. However, the UK has (often even before the introduction of the re-entry charge and – according to Baker – always since the introduction of section 10A in 1998)<sup>26</sup> obtained the inclusion of a provision that preserves the taxing right of the previous state of residence. In fact, this provision has avoided a case of tax treaty override with reference to the double tax convention concluded between Italy and the United Kingdom. It is worth noting that in the provision indicated by Baker as the typical proposed by the United Kingdom<sup>27</sup> the last sentence of art. 13(5) introduced in the treaty concluded between Italy and the UK *((c) is not subject to tax on those gains in the other Contracting State* – see above) lacks. Exactly this last sentence, which is clearly aimed at avoiding double taxation, has excluded a tax treaty override in the case specifically analyzed only because Italy (peculiarly) does not tax individuals shareholders upon their transfer of residence.

To conclude, it is important to point out that in 2005 a case of legislative tax treaty override was realized in the United Kingdom<sup>28</sup> and, as showed above, it has had overriding effects also on the treaty concluded with Italy. The Finance (No 2) Act 2005 changed the previous regime and clearly established that taxpayers can no longer claim relief under an existing tax treaty in order to avoid taxation of capital gains. The domestic re-entry charge shall apply notwithstanding any international treaty provision. Again a legislative provision was passed and it simply and directly excluded the application of international tax treaties.

#### **4. CFC legislation based on a transactional method: a further distinction**

There are a few countries<sup>29</sup> that apply a CFC regime based on a so-called transactional method. This method is characterized by the fact that only specific items of income are covered by the CFC regime at issue. Transactional CFC

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<sup>25</sup> Morton, P. and Sykes, L., *United Kingdom*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 809.

<sup>26</sup> Baker, P., *United Kingdom*, in *The tax treatment of transfer of residence by individuals*, Cahiers de droit fiscal international, volume LXXXVIIa, IFA 2002 Oslo Congress, Kluwer Law International, 2002, p. 571.

<sup>27</sup> Baker, P., *United Kingdom*, in *The tax treatment of transfer of residence by individuals*, Cahiers de droit fiscal international, volume LXXXVIIa, IFA 2002 Oslo Congress, Kluwer Law International, 2002, p. 571.

<sup>28</sup> Morton, P. and Sykes, L., *United Kingdom*, in *Tax treaties and tax avoidance: application of anti-avoidance provisions*, Cahiers de droit fiscal international, volume 95a, IFA 2010 Rome Congress, Sdu Uitgevers, 2010, p. 809.

<sup>29</sup> They are, for example, United States, Germany, Spain, Denmark, Lithuania, Australia.

regimes usually cover passive income and so-called base company income<sup>30</sup>. This income is earned by the controlled foreign corporation and attributed to the shareholders of the CFC resident in the state applying the CFC regime.

The issue regarding the compliance of this CFC method with tax treaties based on the OECD Model Convention presupposes to establish what are the relevant distributive rules which are applicable when such a CFC method is at issue. Some authors consider art. 7(1) of the OECD Model Convention applicable. Other authors are of the opinion that the specifically relevant treaty articles should apply (most commonly articles 10, 11 and 13 of the OECD Model Convention). Indeed, the two positions are based on a different conception about the possible qualification of the income at issue.

According to Rust, qualification depends on the CFC regime. When the CFC legislation is based on a deemed distribution of dividends, art. 10 of the OECD Model Convention applies. On the contrary, when the domestic CFC regime directly attributes income (business profits or more specific items of income) to the foreign shareholders, art. 7 or the more specific distributive rules apply<sup>31</sup>.

Bader maintains that, when the activity carried on by the CFC concerns exclusively the realization of passive income, each specific distributive rule – most likely articles 10, 11 and/or 12, applies.

Application of art. 7 will depend on the activity carried on by the CFC and, in particular, by the possibility to consider this activity as a whole to produce business profits<sup>32</sup>.

In Sandler's opinion a transactional CFC method intrinsically implies a separate consideration of the different items of tainted income attributable to the foreign shareholder. Qualification as business profits would imply taxation of a net value which is in conflict with taxation of passive income<sup>33</sup>.

In this respect it is important what the OECD Report on Base Companies states in its paragraph 50 which is entitled '*Treatment of the taxable amount*': '*The appropriate treatment of the taxable amount under a tax convention between the country of the base company and the country of the taxpayer depends on how the relevant counteracting legislation is regarded. If it attributes the activities or the income of the base company to the taxpayer, one has to look to the composition of the income; it may be*

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<sup>30</sup> '*The base company income comprises the supply of services – and in some cases even the supply of goods – under certain circumstances, especially where the domestic shareholder or other group companies are somehow involved in the transactions.*' See Bader, R. G., *CFC Legislation in the European Union and the Alternative CSC Concept*, (thesis defended at Tilburg University), 2012, p. 228.

<sup>31</sup> Rust A., *National Report Germany*, in Lang, M., Aigner, J., Scheuerle, U. and Stefaner, M. (editors), *CFC Legislation, Tax Treaties and EC Law*, EUCOTAX Series on European Taxation, Volume 8, Kluwer Law International, 2004, pp. 267–268.

<sup>32</sup> Bader, R. G., *CFC Legislation in the European Union and the Alternative CSC Concept*, (thesis defended at Tilburg University), 2012, p. 359 *et seq.*

<sup>33</sup> Sandler, D., *Tax Treaties and Controlled Foreign Company Legislation – Pushing the Boundaries*, Kluwer Law International, 2<sup>nd</sup> edition, 1998, pp. 93, 98.

*composed of different items of income (business profits, interest and royalties) derived from the country of the base company or from any other country **and the provisions that are relevant for these items have then to be applied [emphasis added]**. If the taxable amount is, however, a deemed dividend or a particular capital yield, it is clearly derived from the base company thus constituting income from that company’s country. Even then, it is by no means clear whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 of the OECD Model or as other income within the meaning of Article 21 of the OECD Model. At least under some counteracting measures the taxable amount is treated as a dividend with the result that an exemption, provided for by a tax convention, e.g. an affiliation exemption, is also extended to it ... It is doubtful whether the treaty requires this to be done. If the country of residence considers that this is not the case — and consequently refuses the affiliation exemption for “deemed dividends” — it may face the allegation that it is obstructing the normal operation of the affiliation exemption, by taxing the dividend (in the form of “deemed dividend”) in advance.’<sup>34</sup>*

This last part of the paragraph at issue, which concerns the applicability of art. 10 or art. 21 of the OECD Model Convention, has already been previously examined in chapter five. This last part of the paragraph has been included within paragraph 38 of the OECD Commentary to art. 10. The qualification as dividends of the income taxable under a CFC regime needs to be carefully evaluated, regardless of the qualification made by the state which applies the CFC legislation. Breaches of the relevant tax treaty caused by this qualification cannot be admitted. In this regard, it is important to recall what was emphasized in chapter five about the qualification as deemed dividends and the consequent applicability of art. 10 of the OECD Model Convention. In fact, paragraph 38 of the OECD Commentary to art. 10 – as well as paragraph 50 of the Report on Base Companies – points out the relevance of a tax treaty when CFC legislation is based on a deemed distribution of dividends. From the OECD point of view, the deemed flow of income from the state of source to the state of residence of the shareholder imposes the necessity to identify the applicable treaty provision to guarantee a correct application of the treaty. As explicitly stated in paragraph 38 of the Commentary to art. 10, this is necessary, regardless of the qualification made by the state of residence of the shareholder. Accordingly, paragraph 50 of the OECD Report on Base Companies states that: *‘If It [the relevant counteracting legislation] attributes the activities or the income of the base company to the taxpayer, one has to look to the composition of the income; it may be composed of different items of income (business profits, interest and royalties) derived from the country of the base company or from any other country **and the provisions that are relevant for these items have then to be applied [emphasis added]**.’*

In fact, paragraph 50 of the OECD Report on Base Companies states that the economic nature of the items of income at issue needs to be taken into consideration when the relevance of the OECD Model Convention is at issue.

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<sup>34</sup> OECD, *Double Taxation Convention and the Use of Base Companies*, OECD 1987.



This becomes clearer when the paragraph states that *‘even when’* the CFC regime at issue explicitly qualifies the relevant income as dividends *‘it is by no means clear whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 of the OECD Model or as other income within the meaning of Article 21 of the OECD Model.’* The qualification of income as established by the CFC regime at issue cannot cause a breach of the relevant tax treaty.

In turn, this is the natural consequence of what paragraph 50 states at the beginning. Income that CFC legislation attributes to the foreign shareholders can be composed of different items. In this case *‘the provisions that are relevant for these items have then to be applied [emphasis added]’*. The paragraph mentions business profits as well as interest and royalties. This seems to support the position according to which, when a CFC regime is based on a transactional method, the specifically relevant distributive rules must apply.

After all, this position is perfectly in accordance with the fact that art. 7 of the OECD Model Convention is *lex generalis* that cannot apply when more specific items of income or capital are at issue. Art. 7(4) of the OECD Model Convention states: *‘Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.’*

At this point, the interpretative model can be applied in order to individuate the applicable distributive rules and consequently solve the issue concerning the compliance of the CFC transactional method with the OECD Model Convention.

**1. The rightly applicable distributive rule needs to be individuated. The individuation of the rightly applicable distributive rule needs to be based on the qualification of the relevant item of income or capital by virtue of its very nature, i.e. its source.**

Clearly, in this case the qualification of the relevant income on the basis of its source needs to be coordinated with the fact that the present analysis concerns a legislative method which aims at taxing only specific items of income. This means that the principle usually applied in civil law countries and according to which income deriving from certain business activities is automatically qualified as business income cannot be applied. This would distort the purpose of the legislation at issue. The consequence is that the nature and purpose of the transactional method require to consider separately each item of income under the relevant distributive rules.

When deemed dividends are at issue, the analysis previously conducted in chapter five is relevant.

The following example will take into consideration the case in which a controlled foreign corporation receives royalties. Accordingly, we assume that royalties earned by a CFC are attributed to its foreign shareholder.

Art. 12 of the OECD Model Convention needs to be analyzed.

**2. The exact relationship between the constituent elements of the relevant distributive rule and domestic law needs to be evaluated. Vogel’s**



**model of distributive rule can be used for this purpose. It is necessary to establish to what extent state sovereignty has been limited, i.e. to what extent the possibility to apply domestic law has been limited. The exact relationship between the domestic taxing provisions and the treaty relieving provisions needs to be established.**

Art. 12 of the OECD Model Convention establishes:

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.
2. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.
3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.
4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention

If we apply Vogel’s model of distributive rule to the article at issue this is the result:

## II Substantive requirements

- 1 Designation of the particular object under internal tax law to which the rule will apply (the ‘*Objektatbestand*’ such as ‘income’, ‘profit’, ‘capital’, etc.)  
**> income:royalties**
- 2 Designation of the particular requirements under which the distributive rule will apply (the ‘*Metatatbestand*’):
  - a) Designation of certain characteristics of the tax object that give rise to tax liability: the ‘source’ (‘income from immovable property’, ‘profits of an enterprise’) **> payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph**

**films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.**

- b) Designation of certain characteristics of the tax object that determine how the **amount** of tax liability is measured (Swiss literature refers to this as 'tax separation' (*Steuerausscheidung*), i.e. exclusion from taxation of certain items of income > **The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.**
- 3. Connection between the *Metatatsbestand* and the taxpayer: 'attribution of tax object' ('income derived by a resident') > **Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State**
- 4. Connection between the *Metatatsbestand* and the taxing State(s): 'connecting factor' either
  - a) by a characteristic of the taxpayer (residence, citizenship) > **residence of the beneficial owner**
  - or
  - b) by characteristics of the transaction or event (e.g. the situs of immovable property)

Article 12 applies to a specific item of income: royalties. According to paragraph 2, the provision at issue covers '**payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience**'.

Royalties which derives from a contracting state are taxable in the hand of the beneficial owner resident in the other contracting state.

The attribution of the taxable object to the taxable subject takes place on the basis of two pre-conditions: residence in the other contracting state and status of beneficial owner.

Furthermore, the attribution of the taxable object to the taxable subject is exclusive. Royalties are taxable exclusively in the state where the beneficial owner is resident.

Only when the beneficial owner has a permanent establishment in the state where the royalties arise and the right or property in respect to which the royalties are paid is effectively connected with such permanent establishment,

taxes are paid in the state of the permanent establishment under art 7 of the OECD Model Convention.

Two situations are possible: the CFC can receive royalties from the state of residence of the foreign taxpayer (the state that wants to apply the CFC legislation) or from a third state.

De Broe is of the opinion that when the controlled foreign corporation receives income from a third state, the only relevant treaty is the treaty concluded between the state where the controlled foreign corporation is resident and the third country. Since this treaty does not affect the relationship between the state that applies the CFC legislation and the state where the CFC is resident, no obstacle exists in order to apply the relevant CFC legislation.

According to De Broe, different is the case when the item of income at issue is paid to the controlled foreign corporation by the shareholder resident in the state that wants to apply the CFC legislation. In this case, taxation under a CFC regime should follow the provisions contained in articles 10, 11 and 12 (indeed, the author refers to the most common situations, where dividends, interests and royalties are at issue).

In case the relevant income can be qualified as dividends or interests taxation is due in the state where income is received (the state where the CFC is resident) while the other state (the state that applies the CFC legislation) can levy a withholding tax in conformity with the specific provision at issue.

Accordingly, De Broe maintains that, when the relevant income can be qualified as royalties, article 12 applies. In this case royalties can be taxed only in the hands of the controlled foreign corporation when it is also the beneficial owner of the royalties. CFC legislation cannot be applied.

In substance, De Broe applies the relevant treaty provisions and limits taxation under CFC legislation to the extent that taxation is allowed under the relevant treaty provision. Taxation in the hands of the foreign shareholder simply follows the provisions of the relevant treaty articles.

I do not agree with the distinction made by De Broe. Establishing whether CFC legislation can be applied necessarily means to take into consideration the relationship between the state where the CFC is resident and the state of residence of the foreign shareholder. What we need to establish is whether the tax treaty concluded between the state of residence of the CFC and the state of residence of the shareholder allows to attribute to the shareholder royalties that the CFC has received. There is no difference whether the CFC has received royalties from a third state or from the state of residence of the shareholder.

According to art. 12, taxation is possible only in the state of residence of the CFC (which is also beneficial owner). From the application of Vogel's model of distributive rule it is clear the existence of a unique connection, in terms of tax liability, on the one hand, between the taxable income and the subject that has received royalties (which is the only possible taxable subject) and, on the other hand, between the taxable subject and the state that has the power to tax (which can only be the state of residence of the corporation that has received the

relevant income). According to art. 12(1), *‘Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State’*.

No parallel attribution of taxable income to taxable subject is possible by virtue of a CFC regime.

This position is strengthened by the definition of royalties that is contained in article 12 (2) of the OECD Model Convention: *‘The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.’*

Art. 12, analogously to art. 10, which has been analyzed in chapter five, refers to the *payment* of royalties. The term payment is not defined within the text of the Model Convention.

**3. If the rightly applicable distributive rule uses terms which are not defined within the text of the relevant treaty art. 3(2) of the OECD Model Convention mandatorily applies. The state that applies the treaty uses the domestic definition applied within the state of source. The domestic definition is used as existing at the moment the treaty is applied unless the context otherwise requires. Precedence is given to a domestic investigation about the correspondent domestic definition even if it has been modified after the conclusion of the relevant tax treaty (ambulatory interpretation). Only if the treaty context requires otherwise, which also means that the context can clearly be considered the expression of the common intention of the parties, a contextual definition will apply. The OECD Commentaries are also included within the notion of context. It is, however, necessary to prove that in the concrete case at issue they actually express the common intention of the contracting states.**

The term ‘paid’ is not defined within the text of the OECD Model Convention. This leads to the application of art. 3(2). It is widely accepted that this is a case when the context requires otherwise since the concept of payment is clearly defined within the OECD Commentary and its definition can be considered as expression of the intention of the treaty parties.

Paragraph 8.3 of the OECD Commentary to art. 12 states that *‘[t]he word “payment”, used in the definition, has a very wide meaning since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom.’*

Paragraph 7 of the OECD Commentary to art. 10 states that *‘... [t]he term “paid” has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or by custom’*.

Exactly the same formula is used with regard to article 11 of the OECD Model Convention and expressed in paragraph 5 of its Commentary.

The term payment, under art. 12, has, therefore, a concrete meaning and always involves ‘*the obligation to put funds at the disposal of the creditor*’.

**4. When the relevant item of income or capital is domestically qualified on the basis of fictions or lump-sum applies, the compliance of this fictitious qualification or the use of lump-sum needs to be evaluated on the light of the previous (see point No.1) qualification based on the very nature of the item of income or capital at issue on the basis of its real source.**

This is not the case at issue. The transaction method is not based on recharacterization of income.

**5. In particular, an amendment subsequent to the conclusion of the relevant tax treaty cannot recharacterize items of income and capital or introduce the payment of lump-sum that determine a shift in the taxing power of the contracting states. This amendment is illegitimate when it determines the application of a distributive rule favourable to the amending contracting state but which is not the distributive rule rightly applicable on the basis of the qualification of the relevant item of income or capital on the basis of its very nature. In this case a tax treaty override occurs.**

The problem in the case at issue, as well as with regard to the application of CFC legislation in general, does not involve a shift in the allocation of the taxing power rather than the possibility to attribute income to a subject different than the subject that the tax treaty at issue considers liable to tax. The main concern is, therefore, whether the state of residence of the CFC’s foreign shareholder has the power to tax the foreign shareholder or this taxing power (state sovereignty) has been limited by the relevant tax treaty.

**6. Fictions regarding the residence of taxpayers cannot completely lack a nexus with the state claiming taxing rights. When a provision concerning fictitious residence is introduced after the conclusion of the relevant tax treaty and it is not based on any concrete nexus with the state claiming taxing rights, there is an illegitimate attribution of taxing power that determines a case of tax treaty override.**

This point is not relevant in the case at issue. CFC legislation is not based on provisions which introduce fictitious residence.

**7. More in general, tax treaty override occurs whenever an amendment subsequent to the conclusion of a tax treaty extends the taxing power of the amending contracting state beyond the limits established by the relevant distributive rule so that domestic taxing legislation becomes wider than the treaty relieving provisions.**

This is exactly the problem in the case at issue. If we assume that – after the conclusion of a tax treaty which follows the OECD Model Convention – a state has introduced a CFC regime based on a transactional method that covers taxation of royalties, the application of the new regime for treaty purposes will determine an extension of the taxing power of the amending state beyond the limits established by art. 12 of the OECD Model Convention.

The treaty provision at issue clearly establishes that *‘Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State’*. Art. 12 establishes a unique relationship, in terms of tax liability, between the state of residence of the controlled foreign corporation and the state where it is resident, i.e. only the state where the CFC is resident has the right to tax the royalties earned by the CFC itself. This means that art. 12 has limited the taxing power of the contracting state where the foreign shareholders are resident. This state cannot tax the royalties earned by the CFC in the hands of its foreign shareholders. In the previous chapter it has been proved that the OECD Model distributive rules affect tax liability and regulate the relationship concerning the attribution of a taxable object to a taxable subject. No parallel attribution of royalties to the foreign shareholders of the CFC is possible under art. 12 of the OECD Model Convention.

In addition, art. 12 subordinates the taxation of royalties to their actual payment. Only royalties that have been effectively paid can be taxed. The term ‘payment’ has a concrete meaning that, according paragraph 8.3 of the OECD Commentary to art. 12, implies *‘the obligation to put funds at the disposal of the creditor’*. The mere attribution of royalties does not allow taxation under art. 12 of the OECD Model Convention.

To conclude, a tax treaty override is realized when a state introduces CFC legislation based on a transactional method that imposes taxation of royalties and applies the CFC regime for treaty purposes. In this case the amending state extends its taxing power beyond the limits established by art. 12 of the OECD Model Convention.

**8. A tax treaty override is furthermore realized when domestic legislation which has been unilaterally introduced after the conclusion of a tax treaty has the actual purpose of preventing the application of the treaty.**

This point is not relevant in the specific case at issue. On the contrary, CFC legislation is based on a parallel exercise of taxing power.

**9. Saving clauses can be introduced in the specific tax treaty.**

This point is not relevant in the case at issue

**10. Anti-abuse clauses can be introduced in the specific tax treaty.**

As emphasized in the conclusions of chapter five, which has been dedicated to the relationship between domestic anti-abuse provisions – including CFC legislation

– and treaty provisions, the introduction of specific or general anti-abuse clauses is the only way to *justify* tax treaty override in case of conflicts with previously concluded tax treaties. Once confuted the position of the OECD, according to which tax treaties based on the OECD model Convention are not affected by domestic anti-abuse legislation, and proved that – in fact – conflicts can arise between domestic anti-abuse rules and treaty provisions, the introduction of anti-abuse clauses allow the contracting states to apply CFC legislation even in case of conflicts with a tax treaty.

#### *4.1 Concluding remarks on the CFC transactional method*

The decision to treat the CFC transactional method in a separate chapter than the chapter specifically dedicated to the CFC legislation has been, indeed, intentional. The reason has been implicitly showed by the analysis conducted in the previous paragraph through the application of the interpretative model. The peculiarities of the transactional method and, mostly, the fact that it concerns only specific items of income require a kind of analysis that presupposes the conclusions drawn in chapter five. The outcome that the OECD Model distributive rules affect tax liability has been essential in order to establish that the evaluation of the compliance of CFC legislation with a tax treaty based on the OECD Model Convention always presupposes the individuation of the relevant distributive rule and consequently the individuation of the limits to the taxing power of the state that wants to apply the CFC legislation. On the basis of these evaluations, it has been possible to establish that a transactional method requires the application of the specific distributive rule which is relevant on the basis of the specific nature of the item of income at issue. Once solved this essential preliminary point, the analysis can be extended, on the basis of the interpretative model, to different regimes and different tax treaties.

## Chapter VII

### *Conclusions: a legal systematization of tax treaty override*

#### **1. The origin and nature of tax treaty override: an investigation that starts within the international legal system**

Starting point of a study aimed at a legal systematization of tax treaty override necessarily is an investigation about the origin and nature of tax treaty override. This investigation, however, presupposes a concrete understanding of the application of international law within national legal systems. The country analysis conducted in the second chapter of the present study has showed that some states apply international law automatically and directly while other states do not admit the application of international law as such. Therefore, they transform and incorporate international law into national law. The fact that states actually decide what effect international law has within their own national legal system has direct consequences on the admissibility of tax treaty override. More specifically, those states that apply international law automatically and directly do not admit tax treaty override because international law prevails over national law. On the contrary, those states that transform and incorporate international law into national law admit tax treaty override. The legitimacy of tax treaty override within these national legal systems is essentially based on the transformation of international law. When international law is incorporated into national law it acquires the same rank that the incorporating law has within the national hierarchy of law. As a consequence, the common interpretative rule *lex posterior abrogat priori* can be applied. The domestic law incorporating the international treaty can be amended by a subsequent domestic law which has the same rank within the national hierarchy. The result is that the incorporated international agreement is, in fact, unilaterally amended. In addition, it is amended through the application of rules which, from a strictly national point of view, are legitimate. Cassese maintained that the variety of national systems with regard to the implementation of international law is the result of the conviction of states that “the translation of international commands into domestic legal standards is part and parcel of their sovereignty”<sup>1</sup>.

The point is, therefore, to understand whether state sovereignty is limited by international law.

This is the crucial issue of the first part of this study. If international law is objectively binding upon states, their sovereignty is limited by a valid international

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<sup>1</sup> Cassese, A., *International Law*, Oxford University Press, second edition, 2005, p. 220.



agreement whose effects cannot vary at discretion on the basis of the will of each individual state.

The theories of Lauterpacht and Tanzi have been applied in order to address this crucial issue.

Both authors recognize the objectively binding nature of international law as created by states which are the main actors within the international community. According to Lauterpacht, *‘There is no reason why the original hypothesis in international law should not be that **the will of the international community must be obeyed [emphasis added]**. It could be said, by way of further explanation, that although in many cases the will of the international community must be deduced from the mere fact of its existence, i.e. from ‘the reason of the thing’, **the organs of the formation of the will of the international community are, in the absence of an international legislature, States themselves, their consent being given by custom or treaty, and being capable of impartial ascertainment and interpretation by international tribunals.** An initial hypothesis expressed in the terms of *voluntas civitatis maximae est servanda* would point, as the source of law, to the will of the international society expressing itself in contractual agreements between its constituent members, in their customs, and in the general principles of law which no civilized community can afford to ignore; it would refer to the *civitas maxima*, as meaning that super-State of law which **States, through the recognition of the binding force of international law qua law, have already recognized as existing over and above the national sovereignties**; it would be compatible with the fact that the authority of that super-State extends, so far, not so much to the creation of new concrete rules as to the maintenance and respect of obligations already expressed or contracted by implication’<sup>2</sup>.*

Perfectly in accordance, Tanzi maintains: *‘Firstly, nation-states came into being de facto, claiming and attaining on the basis of reciprocity prerogatives and limitations that would make up the principle of sovereignty. Expectations and consequent claims of reciprocal conduct represent the meta-juridical and, at the same time, legal constituent element of the international legal community.*

*Secondly, such sovereign actors, so self-conceived and self-perceived, would produce and utilize rules on recognition, as well as the material rules thereby produced’.*<sup>3</sup>

The same creative process is at the basis of the principle of sovereign equality which, according to Tanzi, is the *‘true grund-norm’*<sup>4</sup> of international law. This principle has a central role when an international agreement is concluded. Not only the equal position of the parties to it is guaranteed, but also the protection of reciprocity and legitimate expectations becomes essential.

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<sup>2</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, pp. 429– 430.

<sup>3</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 150.

<sup>4</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 150.

International law has no parliamentary origin. However, this circumstance is not enough to exclude its binding effect. This is a consequence of the fact that international law is materially created by those subjects that are the main actors within the international community, i.e. by the states.

International law is literally 'created' by states through their action, i.e. through their participation in the international community. '*Expectations and consequent claims of reciprocal conduct*' determine the passage from a material act of participation to recognition as *Law*. International law stems from the material creation by states and it reaches the status of *Law* through recognition and consent of states. At this point the first research question can be answered: '*Is an international agreement binding upon states so that their sovereignty is effectively limited and, as a consequence, states are not allowed to transform and incorporate international law into national law and subsequently apply the rule *lex posterior abrogat priori* when the result is that a tax treaty override is - in fact - realized ?*'

The answer to this question is closely connected to the following sub-questions, as indicated in the introduction to this study: (1) '*Are states allowed to regulate at discretion the effects of international law within their national legal system?*', (2) '*Can international law be considered objectively binding upon states ?*' and (3) '*Is tax treaty override a violation of international law?*'.

International law is binding upon states because it is based on the consent and recognition of states themselves. As a consequence international law limits state sovereignty.

At this point, a distinction needs to be made. It is important to recall that, as emphasized in the second chapter of this study, international law has no rules that oblige states to follow a specific procedure of implementation. As a consequence, states are allowed to incorporate and transform international law into national law. Nevertheless, this possibility cannot be a way to actually breach international law, in general, and an international agreement, more specifically. This means that the transformation into national law does not allow states to apply the rule *lex posterior abrogat priori* when its application concretely determines a unilateral amendment to the incorporated international agreement and, therefore, a treaty override.

In addition, art. 27 of the Vienna Convention on the Law of Treaties, by codifying a principle of customary law, states that a breach of an international agreement cannot be justified by virtue of national law.

In conclusion, even if, on the one hand, the international legal system allows states to transform international law into national law and, on the other hand, the application of the rule *lex posterior abrogat priori* is legitimate from a strictly national point of view, state sovereignty is limited through the conclusion of an international agreement. Consequently, a validly concluded international agreement forbids states from unilaterally re-extending their sovereignty through the application of the rule *lex posterior abrogat priori*. When this re-extension occurs international law is violated through the realization of a tax treaty override.

It is worth noting that the theory supported in the present study connects the limitation of the state sovereignty directly to the international agreement which is binding in itself. The rule *pacta sunt servanda* is not considered the source of the binding effects of an international agreement. This is an extremely important aspect of this study because the rule *pacta sunt servanda* is external to the international agreement and in addition it specifically concerns the performance of a treaty instead of its content.

The occurrence of a tax treaty override can be analyzed only with reference to the content of the international agreement and cannot depend on the scope and meaning of a rule which guarantees the effects of an international agreement but it is not the source of its legitimacy.

The importance of this differentiation is emphasized by Lauterpacht: ‘*The hypothesis pacta sunt servanda has proved a beneficent transition from a doctrine of international law based on the will of sovereign States to a doctrine of the law of nations based on the law’s impersonal sovereignty.*

*But at present it contains the two incongruous elements. It pays homage both to the will of States as the fountain of law and to the heteronomous command of the rule of law. But the synthesis is only one of words; it is not, and cannot be, one of substance. A more satisfactory solution can be found in a hypothesis which, by courageously breaking with the traditions of the past period, incorporates the rational and ethical postulate, which is gradually becoming a fact, of an international community of interests and functions.*’<sup>5</sup>

It is clear that if the objective binding nature of international law is recognized the rule *pacta sunt servanda* is also, as a rule of international law, objectively binding. On the contrary, when the objectively binding nature of international law is denied, the rule *pacta sunt servanda* either loses its objectively binding nature and becomes depended on the will of states or it is considered a juridically indemonstrable rule<sup>6</sup>.

Immense is the variety of theories that, on the basis of even completely opposite points of view, explain the nature of international law.

Lauterpacht and Tanzi have a common starting point in evaluating the nature of international law. This starting point is the existence of an international community. This is the reason that led me to found this study on their theories. International law does not stem from an organ with representative function, like a national parliament. In addition, the jurisdiction of international tribunals is only consensual. However, states have created an international community where they operate politically, economically and socially every day. The existence

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<sup>5</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, p. 430.

<sup>6</sup> In this respect, see *infra* chapter II.

of an international community imposes the existence of law that governs that community. After all, states acting within the international community create rules because they need rules that govern their relationships. It is not possible to apply these rules at discretion. It would imply to admit that the international community is governed by power and that states accept unequal relationships between themselves. However, the existence of the United Nations, the existence of international tribunals, the existence of the European Convention on Human Rights and the relative Court show that, although – undoubtedly – power still has a big impact on the effect of international law, the direction of the international community as a whole is at the opposite. This direction can be guaranteed only through a coherent acceptance of the binding effect of international law.

## 2. Tax treaty override as a source of international responsibility

Once established that tax treaty override realizes a violation of international law, the following issue has been addressed: *‘Does tax treaty override give rise to state responsibility under the Draft Articles on State Responsibility?’*

It is a general principle of the international legal system that any violation of international law gives rise to state responsibility. Already in the late twenties of the last century the Permanent Court of International Justice stated that *‘[i]t is a principle of international law that the breach of an engagement involves an obligation to make reparation in an adequate form. Reparation therefore is the indispensable complement of a failure to apply a convention and there is no necessity for this to be stated in a convention itself.’*<sup>7</sup>

In the *Interpretation of the Peace Treaties case (Second Phase)*, the International Court of Justice stated: *‘... it is clear that refusal to fulfil a treaty obligation involves international responsibility’*<sup>8</sup>

This fundamental principle of international responsibility is now clearly established by the *‘Draft Articles on Responsibility of States for Internationally Wrongful Acts’*<sup>9</sup>. Its article 1 states that *‘every internationally wrongful act of a State entails the international responsibility of that State.’*

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<sup>7</sup> Permanent Court of International Justice, *Factory at Chorzów* case, Series A, No. 9, judgment No. 8, 26 July 1927, p. 21; Permanent Court of International Justice, *Factory at Chorzów* case (Merits), Series A, No. 17, judgment No. 13, 13 September 1928, p. 29.

<sup>8</sup> International Court of Justice, *Advisory Opinion of 18 July 1950 – Interpretation of Peace Treaties with Bulgaria, Hungary and Romania (Second phase)*, p. 228.

<sup>9</sup> Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001. The text of the draft articles is reproduced in the Annex of a United Nations General Assembly resolution adopted on the 12<sup>th</sup> of December 2001 (A/RES/56/83).

Article 2 specifies that *‘there is an internationally wrongful act of a State when conduct consisting of an action or omission: (a) is attributable to the State under international law; and (b) constitutes a breach of an international obligation of the State.’*

Article 2 of the draft articles does not mention damage as a constituent element of an internationally wrongful act.

Moreover, the Commentary to draft article 2 specifies that the need of a material or moral damage to occur in order to make state responsibility arising depends exclusively on the content of the primary obligation<sup>10</sup>. The material or moral damage is an indispensable element of state responsibility only when it is required by the primary obligation. This is confirmed by draft article 12 which specifies that *‘there is a breach of an international obligation by a State when an act of that State is not in conformity with what is required of it by that obligation, regardless of its origin or character’*.

Since the Draft Articles on State Responsibility are based on the concept of ‘absolute responsibility’ – as it appears clear from the mentioned provisions – any breach of a treaty provision which results in an act that is not in conformity with the terms of that provision is an internationally wrongful act<sup>11</sup>.

Given these premises, tax treaty override can be qualified as a wrongful act that gives rise to international responsibility of states.

Nevertheless, there is a contradiction between the first and the second part of the draft articles. While draft articles 1 and 2 only require the violation of an international obligation in order to qualify an internationally wrongful act, according to draft article 31, reparation is only possible in case a material or moral damage has been caused. Draft article 31(2) states that *‘injury includes any damage, whether **material or moral [emphasis added]**, caused by the internationally wrongful act of a State’*.

Furthermore, *‘the provisions on restitution (Article 35) and compensation (Article 36) seem intended to make reparation for a material injury, and satisfaction (Article 37) for a moral one’*<sup>12</sup>.

In substance, the Draft Articles on State Responsibility do not explicitly state the right to obtain reparation in absence of a material or moral damage. And it is clear that if reparation is not guaranteed – in fact – there is no responsibility. This raises doubts about the possibility that a legislative tax treaty override, which is based on the sole conflict of laws and is, therefore, a legal injury, can give rise to state responsibility under the Draft Articles on State Responsibility

<sup>10</sup> Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, cit., Commentary on art. 2, par. 9, p. 36.

<sup>11</sup> Shatabai, R., *Breach of Treaty in the Codification of the Law of State Responsibility*, Martinus Nijhoff Publishers, 2007, p. 517.

<sup>12</sup> Barboza, J., *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, p. 9.

(‘Does legislative tax treaty override, as a legal injury, give rise to state responsibility under the Draft Articles on State Responsibility?’)

As clarified in the course of this study, a judicial tax treaty override is based on the actual application of domestic law that, being adopted after the conclusion of a tax treaty, determines a material extension of the taxing power of the amending contracting state. Consequently, the tax base in the other contracting state results eroded. In short, a judicial tax treaty override causes a damage to the other contracting state.

On the contrary, no damage – at least moral or material – is caused when a legislative tax treaty override occurs. A legislative tax treaty override stems from the mere conflict between domestic law and a previous treaty.

This conflict as such realizes a violation (through a *de facto* unilateral amendment) of a tax treaty but it does not cause a material or moral damage to the other contracting state.

I agree with Tanzi and Barboza when they maintain that a violation of international law inherently causes a breach of the legal system and, therefore, the violation of a subjective legal interest of the injured state. Although no material or moral damage is caused, the sole breach of an international obligation weakens both the international legal order and the specific rights of the injured State.

Agreeably, Barboza connects the first and the second part of the Draft Articles on State Responsibility by arguing that the ultimate aim of the draft articles in general and of draft article 1 specifically is ‘the return to legality’<sup>13</sup>.

In addition, the commentary on draft article 31 makes it clear that the notion of reparation which is applicable is that established by the Permanent Court of International Justice in the representative *Factory at Chorzów* case: ‘*The essential principle contained in the actual notion of an illegal act - a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals - is that **reparation must, as far as possible, wipe out all the consequences of the illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed [emphasis added]***’.<sup>14</sup>

In short, this means that reparation should essentially guarantee ‘return to legality’.

The need of returning to legality allows to include ‘legal injury’ within the notion of internationally wrongful act. Thus, legislative tax treaty override can be considered an internationally wrongful act that gives rise to state responsibility.

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<sup>13</sup> Barboza, J. *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, pp. 10, 22.

<sup>14</sup> Permanent Court of International Justice, *Factory at Chorzów* case (Merits), Series A, No. 17, judgment No. 13, 13 September 1928, p. 47.

### 3. An ‘interpretative model’ to identify cases of tax treaty override

The conclusion that an international agreement is binding in itself and it concretely limits state sovereignty so that the extent of the sovereignty of states cannot be considered discretionally depended on their will has had a major impact on the analysis specifically concerning tax treaty override. The international agreement is the only parameter to evaluate the possible occurrence of a tax treaty override. For this reason this study has considered extremely important an in depth analysis about the peculiar structure and functioning of the OECD Model Convention. The close and almost inextricable interrelation between tax treaty provisions and domestic law has been illustrated to clarify how difficult it can be to individuate the exact balance that a tax treaty creates between them. Individuating this balance means to individuate to what extent the contacting states sovereignty has been limited. The OECD Model Convention is mainly constituted by formal distributive rules while taxation is based on substantive domestic law. The relevant distributive rule is the point of reference in an interpretative process aimed at establishing whether a case of tax treaty override has occurred.

Vogel’s model of distributive rule has been applied in this study in order to concretely understand the measure of the incidence of a tax treaty based on the OECD Model Convention on the application of domestic taxing law.

This study has, therefore, answered the following sub-question: *‘How to define exactly the relationship existing between a tax treaty provision and national law in order to establish to what extent a concluded international agreement has limited the contracting states sovereignty?’*.

The answer to this question is the result of the interpretative process developed in the main part of this study and that has been synthesized in the following ‘interpretative model’:

1. The rightly applicable distributive rule needs to be individuated. The individuation of the rightly applicable distributive rule needs to be based on the qualification of the relevant item of income or capital by virtue of its very nature, i.e. its source;
2. The exact relationship between the constituent elements of the relevant distributive rule and domestic law needs to be evaluated. Vogel’s model of distributive rule can be used for this purpose. It is necessary to establish to what extent state sovereignty has been limited, i.e. to what extent the possibility to apply domestic law has been limited. The exact relationship between the domestic taxing provisions and the treaty relieving provisions needs to be established;
3. If the rightly applicable distributive rule uses terms which are not defined within the text of the relevant treaty art. 3(2) of the OECD Model

Convention mandatorily applies. The state that applies the treaty uses the domestic definition applied within the state of source<sup>15</sup>. The domestic definition is used as existing at the moment the treaty is applied unless the context otherwise requires. Precedence is given to a domestic investigation about the correspondent domestic definition even if it has been modified after the conclusion of the relevant tax treaty (ambulatory interpretation). Only if the treaty context requires otherwise, which also means that the context can clearly be considered the expression of the common intention of the parties, a contextual definition will apply. The treaty context could also limit the possibility of an ambulatory interpretation and requires the application of a term as defined under domestic law at the moment of the conclusion of the relevant treaty. Treaty context and domestic law can also be mutually applied. When the treaty context does not contain an exhaustive definition but only elements that delimit the domestic definition, this domestic definition will be applied within the limits established by the context. The OECD Commentaries are also included within the notion of context. It is, however, necessary to prove that in the concrete case at issue they actually express the common intention of the contracting states. The applicable OECD Commentaries are those existing at the moment of the conclusion of the relevant treaty. Art. 3(2) also admits fictitious definitions to the extent that they are compatible with the wording and context of the relevant distributive rule. In general, the use of the terms ‘derived’ and ‘paid to’ excludes the possibility to use fictitious qualifications of items of income and capital;

4. When the relevant item of income or capital is domestically qualified on the basis of fictions or lump-sum applies the compliance of this fictitious qualification or the use of lump-sum needs to be evaluated on the light of the previous qualification based on the very nature of the item of income or capital at issue on the basis of its real source;
5. In particular, an amendment subsequent to the conclusion of the relevant tax treaty cannot recharacterize items of income and capital or introduce the payment of lump-sum that determine a shift in the taxing power of the contracting states. This amendment is illegitimate when it determines the application of a distributive rule favourable to the amending contracting state but which is not the distributive rule rightly applicable on the basis of the qualification of the relevant item of income or capital on the basis of its very nature. In this case a tax treaty override occurs;

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<sup>15</sup> For the exceptional cases when this rule does not apply, see *infra* chapter IV, footnote No. 29.



6. Fictions regarding the residence of taxpayers cannot completely lack a nexus with the state claiming taxing rights. When a provision concerning fictitious residence is introduced after the conclusion of the relevant tax treaty and it is not based on any concrete nexus with the state claiming taxing rights, there is an illegitimate attribution of taxing power that determines a case of tax treaty override;
7. More in general, tax treaty override occurs whenever an amendment subsequent to the conclusion of a tax treaty extends the taxing power of the amending contracting state beyond the limits established by the relevant distributive rule so that domestic taxing legislation results wider than the treaty relieving provisions;
8. A tax treaty override is furthermore realized when domestic legislation which has been unilaterally introduced after the conclusion of a tax treaty has the actual purpose of preventing the application of the treaty;
9. Saving clauses can be introduced in the specific tax treaty;
10. Anti-abuse clauses can be introduced in the specific tax treaty;
11. When more than one interpretation is possible, priority needs to be given to the interpretation that conciliates the application of both domestic law and treaty provisions.

#### **4. A definition of tax treaty override and all its constituent elements**

For general international law purposes the term ‘treaty override’ refers to any breach of an international agreement in accordance with the common meaning of the verb ‘override’ (or ‘overrule’ which is also commonly used to indicate that a treaty has been superseded). The term ‘treaty override’ has instead acquired a specific connotation for tax treaty purposes.

‘Tax treaty override’ can be defined as the unilateral amendment of an international treaty through domestic legislation adopted or applied by one of the contracting states after the moment the treaty has become binding upon its parties.

Tax treaty override, therefore, stems from a conflict between laws: domestic legislation is in conflict with one or more provisions of a previous international treaty.

A specific characteristic of tax treaty override derives from the absolutely peculiar structure and functioning of the OECD Model Convention. While taxation is governed by domestic law, tax treaties based on the OECD Model Convention are mostly made of only formal distributive rules which limit the application of

domestic taxing legislation. Thus, the OECD Model Convention determines the application for tax treaty purposes of legislation which is in principle adopted for domestic purposes only. As a consequence, the moment a tax treaty override is actually realized depends on the scope of domestic law. When its scope exactly coincides with the scope of one or more provisions of a previous international treaty and domestic law is specifically meant to apply for tax treaty purposes as well, a tax treaty override is realized at the moment domestic law is passed by a national parliament. This was, for example, the tax treaty override realized when in 2005 the application of the Canadian GAAR was extended – with retrospective affect – to apply in respect to all the existing tax treaties<sup>16</sup>.

Different is the case when newly adopted or amended domestic law is not meant to be applied for tax treaty purposes. This could, for example, be the case of the Dutch ‘typical wage rule’<sup>17</sup>. That legislation was a domestic legislation in principle meant to apply for domestic purposes although, given its content, possibly applicable for treaty purposes as well. In this case, the mere adoption of domestic law cannot realize a tax treaty override. This clearly depends on the fact that a tax treaty cannot limit the sovereignty of contracting states in order to adopt or amend domestic law. In this case a tax treaty can only limit the right of a contracting state to apply domestic law for treaty purposes when domestic law is in conflict with the relevant treaty. In this case the actual realization of a tax treaty override is subordinated to the application of domestic law.

The distinction between the moment domestic legislation is passed by a national parliament and its application is consequently at the base of the distinction between legislative tax treaty override and judicial tax treaty override. In the first case a tax treaty override stems from the mere conflict between national law and one or more provisions of a previous international treaty. A legislative tax treaty override is, therefore, possible only when there is exact coincidence between the scope of domestic law and the scope of one or more provisions of an international treaty and, in addition, domestic legislation is specifically adopted for treaty purposes. This usually happens when the domestic legislature expresses its will to override one or more tax treaties (commonly the overriding will is expressed with regard to all the concluded tax treaties). The 2005 amendment to the UK re-entry charge was expressly said to apply notwithstanding the provisions of any concluded tax treaty<sup>18</sup>.

Judicial treaty override is – by definition – based on the application of domestic law. In this case the relevant domestic law has the same scope of one or more provisions of a tax treaty but it is not specifically meant to apply for treaty purposes as well. Domestic law was adopted for internal purposes only. However, the coincidence of scope between domestic law and one or more tax treaty

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<sup>16</sup> See *infra* chapter V.

<sup>17</sup> See *infra* chapter IV.

<sup>18</sup> See *infra* chapter VI.

provisions makes domestic legislation possibly applicable for treaty purposes as well. When this legislation is applied by a national court in conflict with a previous treaty a case of judicial tax treaty override is realized.

It is clear from the above that the express intention of the legislature in order to override a tax treaty is not an essential element characterizing tax treaty override. It has been explained that in case of legislative tax treaty override the scope of domestic law needs to be expressly extended in order to apply for treaty purposes as well. However, this does not necessarily imply the express intention to override a tax treaty. It only implies the intention to apply domestic law for treaty purposes as well, regardless of the awareness of the legislature that a treaty override is in fact being realized.

Judicial treaty override is based on a judicial decision. A judge can intentionally override a treaty or simply realize a treaty override without being aware of it. Roxan explained that *'[a] judicial override may arise because a court is suspicious that provisions of the convention may have a 'disruptive' effect on the domestic tax system. More innocently, it may arise simply because the court is less familiar with the interpretation of tax conventions than with the interpretation of domestic tax legislation. The court may thus find it easier to reach a conclusion by applying purely domestic tax principles.'*<sup>19</sup> In short, a judicial tax treaty override can also be the result of an incorrect application of international law (included the case when national law is incorrectly applied instead of international law).

Finally, the distinction between legitimate and illegitimate tax treaty override needs to be clarified.

As explained above, a treaty override determines a unilateral modification of the agreement as originally made between the parties. It is, however, possible that a tax treaty itself allows to a certain extent an amendment to the original agreement. The analysis of art. 3(2) of the OECD Model Convention has showed that the possibility of an ambulatory interpretation, in fact, allows a partial modification of the original agreement by admitting the application of a domestic definition as amended after the conclusion of the relevant treaty. A tax treaty is, in fact, overridden. However, the parties to the treaty have explicitly agreed upon it. A tax treaty override is realized but this is a case of legitimate treaty override because it is established by the parties to the relevant treaty. For the same reason, it should be excluded that, at least on the basis of the OECD Model Convention, treaty abuse can be considered a justification to override a tax treaty. Unless the contracting states have specifically agreed on the possibility that domestic law can be applied notwithstanding the provision of a tax treaty, abuse does not give rise to a legitimate case of tax treaty override.

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<sup>19</sup> Roxan, I., *Judicial Overrides of Double Tax Conventions: The Case of a Permanent Establishment*, in *Intertax*, Vol. 25 (1997), No. 11, p. 367.

## 5. The application of the ‘interpretive model’

### 5.1 The U.S. exit tax regime

The developed interpretative model has been, first of all, applied to the U.S. exit tax regime introduced in 2008. Section 877A (a)(1) of the Internal Revenue Code establishes ‘*[a]ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value*’.

Since the legislation at issue covers all property, even personal property, owned at the moment of transfer, evaluation about tax treaty override should entail each relevant distributive rule individuated on the basis of the very nature of the specific item at issue. The application of the interpretative model conducted in chapter six covered shareholding and, therefore, taxation of capital gains. The choice was made in order to extend this examination to one of the most common exit tax regime so that more general outcomes could be inferred from the conducted analysis.

The simulation regarded the tax treaty concluded between the U.S. and the Netherlands in 1992.

Two conflicting aspects were highlighted. Essentially, a tax treaty override was realized through the introduction of a fiction – ‘*[a]ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value* – that by anticipating the moment when tax liability arises – in fact – precludes the application of the relevant tax treaty.

In addition, it has been emphasized that the application of an exit tax is legitimate from a domestic point of view only when the state of origin has actually lost its unlimited taxing power on the emigrant taxpayer. This means that an exit tax can be applied only when the taxpayer is, in fact, no longer resident in the state of departure. A tax treaty override is, therefore, realized every time, in breach of art. 13(5) of the OECD Model Convention (the simulation took into consideration the correspondent art. 14(7) of the treaty between the U.S. and the Netherlands) the state of origin exercises its taxing power on a subject which is no longer resident there.

For this reason the introduction of the U.S. saving clause (the treaty concluded between the U.S. and the Netherlands does not contain a saving clause) could avoid a tax treaty override by allowing taxation in the hands of previous residents. The latest version of the saving clause is contained in art. 1(5) of the 2006 U.S. Model Convention. It reads: ‘*Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens.*

*Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, for the period of ten years following the loss of such status be taxed in accordance with the laws of that Contracting State*’

In chapter four it has been emphasized that the OECD Model Convention does not contemplate the case of transfer of residence. Consequently, the right of the state of source to tax accrued income is not protected.

The only way to assure that the state of source can rightly tax income accrued – although not realized during the period of residence – is the introduction of an express provision within tax treaties.

The concept which is at the basis of the U.S. saving clause is a good starting point. A tax treaty should clearly establish the right of the state of source to tax, at the moment of realization, income that accrued during a previous period of residence.

### 5.2 *The UK ‘re-entry charge’*

The interpretative model has subsequently been applied to the UK re-entry charge. I found it interesting to verify whether taxation of capital gains at the moment of return to the state of origin could be a regime admissible under the OECD Model Convention and might represent a solution for those countries that now apply a common exit tax regime.

The legislation at issue is quite peculiar. It is also founded on a fiction. Capital gains realized abroad, by an individual who was resident or ordinarily resident in the UK, on assets that the taxpayer owned while he was resident or ordinarily resident in the UK, are deemed to have been realized in the year of return to the UK.

The anti-avoidance purpose of the legislation at issue is clear. When the taxpayer transfers its tax residence from the UK but he remains abroad only for a short period of time (according to the UK legislation, less than five years), it can be assumed that the transfer was aimed at realizing capital gains abroad. In this case, capital gains are deemed to be realized only in the year of return to the UK and taxed there.

The legislation at issue applies to capital gains in general. This means that the different relevant distributive rules should be examined, on the basis of the specific source of the capital gains, in order to analyze cases of tax treaty override. With the purpose to assure the examination of one of the most important and common situations, shareholding has been taken into consideration in the analysis conducted in chapter six. In this way, coherently with the previous analysis concerning the U.S. regime, the examination had a wide scope and its outcomes can be considered to cover exit tax regimes as well.

UK law was tested under the tax treaty concluded between Italy and the United Kingdom in 1990. Art. 13(4) of the treaty (corresponding to art. 13(5) of the OECD Model Convention) was at issue.

In the specific simulation, the introduction of the re-entry charge in 1998 did not realize a tax treaty override. It was avoided thanks to art. 13(5) of the relevant tax treaty. This article states: *‘The provisions of paragraph (4) of this Article shall not*

*affect the right of a Contracting State to levy according to its law a tax on gains from the alienation of any property derived by an individual who: (a) is a resident of the other Contracting State; and (b) has been a resident of the first-mentioned Contracting State at any time during the five years immediately preceding the alienation of the property; and (c) is not subject to tax on those gains in the other Contracting State’.*

Since Italy does not tax capital gains accrued on shareholding held by individuals, the introduction of the mentioned saving clause avoided the realization of a tax treaty override.

However, the analysis of art. 13(4) of the treaty concluded between Italy and the UK, in the light of Vogel’s model of distributive rule, has showed that, in principle, the UK re-entry charge is not compliant with the OECD Model Convention. In this case a deemed alienation is not at issue. Capital gains are realized on the basis of a real act of disposal. Nevertheless, they are realized abroad while the taxpayer is resident abroad. The UK regime imposes taxation of capital gains that are fictitiously considered to have been realized in the UK. The discrepancy with art. Art. 13(4) (which corresponds to art. 13(5) of the OECD Model Convention) was immediately evident on the basis of Vogel’s model of distributive rule. The article states ‘*Gains from the alienation of any property other than that referred to in the preceding paragraphs of this Article shall be taxable only in the Contracting State of which the alienator is a resident*’. Clearly, the treaty provision at issue, analogously to art. 13(5) of the OECD Model Convention, establishes simultaneity between the status of being a resident of a certain state, the alienation by the same resident in the state of residence, and the right to tax of the same state.

This is exactly the problematic point in the UK legislation at issue. It extends the UK taxing power beyond the limits established by the relevant distributive rule. UK law – again by virtue of a fiction – attributes the taxing power to the UK while capital gains are realized abroad during a period when the taxpayer is resident abroad. Consequently, only the state where the capital gains are realized while the taxpayer was resident there has the right to tax (unless a saving clause is introduced!).

### 5.3. *The transactional CFC method*

Finally, the compliance of the CFC transactional method with the OECD Model Convention has been tested in the light of the developed interpretative model. The peculiarity of this CFC method depends on the fact that it covers only specific items of income. Transactional CFC regimes usually cover passive income and so-called base company income<sup>20</sup>.

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<sup>20</sup> ‘The base company income comprises the supply of services – and in some cases even the supply of goods – under certain circumstances, especially where the domestic shareholder or other group companies are somehow involved in the transactions.’ See Bader, R. G., *CFC Legislation in the*

Establishing the compliance of the CFC transactional method with the OECD Model Convention presupposed to individuate what distributive rules could be considered relevant: art. 7 of the OECD Model Convention which regulates business profits or the distributive rules individually relevant (in the most common situations, articles 10, 11 and 12 respectively governing taxation of dividends, interests and royalties).

In order to conduct this evaluation, the analysis developed in chapter five, which was dedicated to domestic anti-abuse rules and specifically to CFC legislation, was preliminarily essential. In chapter five the position of the OECD according to which domestic anti-abuse provisions, including CFC legislation, do not affect tax treaties has been confuted. Consequently, it has been proved that conflicts can arise between domestic anti-abuse rules and tax treaty provisions. This means that when domestic anti-abuse provisions, including CFC legislation, are in conflict with a previously concluded tax treaty, a tax treaty override can occur. In this case, the possibility to apply the relevant domestic legislation needs to be evaluated on the basis of the specifically applicable distributive rule.

Given these premises, it is clear that when the transactional CFC method is at issue, its compliance with the OECD Model Convention depends on the specific items of income covered. On the basis of the very nature of each item of income the relevant distributive rule is individuated and analyzed in order to verify to what extent the taxing power of the state that wants to apply the CFC legislation has been limited.

In the specific simulation conducted in chapter six, royalties have been taken into consideration. It has been demonstrated that art. 12 of the OECD Model Convention does not allow to tax the royalties received by the controlled foreign corporation in the hands of its foreign shareholders. According to art. 12, royalties can be taxed only in the state of residence of the CFC (when it is also beneficial owner). Art. 12 of the OECD Model Convention establishes that the taxable object (royalties) can be exclusively attributed to a specific taxable subject (the CFC which is beneficial owner of the royalties). No parallel attribution of taxable object to taxable subject is allowed by virtue of CFC legislation.

In addition, art. 12 subordinates taxation of royalties to their actual payment. According to the OECD Commentaries, 'payment' has a concrete meaning that involves the obligation to transfer funds to the creditor. It is excluded that the mere attribution of royalties to the foreign shareholders of a controlled foreign corporation could legitimate taxation under art. 12 of the OECD Model Convention.

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*European Union and the Alternative CSC Concept*, (thesis defended at Tilburg University), 2012, p. 228.

## 6. A few final thoughts on tax treaty override

There are a few final considerations that I would like to bring to the attention of the readers, although they have not been object of specific analysis in the course of this research. They are mostly the result of reflections made during this study and that might represent the ideal continuation of a study on tax treaty override.

### 6.1 *The delicate position of national judges*

First of all it is important to emphasize the delicate position of national judges. It is clear from the above that both national parliaments (through a legislative tax treaty override) and national courts (through a judicial tax treaty override) can give rise to international state responsibility.

This puts national judges in a really delicate position. When in a national legal system there is a provision that imposes the prevalence of international law, a national judge is obliged to observe national legislation and treaty override – excepted cases of mistakes – is avoided.

Nevertheless, when a national system does not expressly prohibit treaty override, the decision of a national judge is based exclusively on interpretation of national provisions. The decision of the highest national court that admits or, in any case, realizes a tax treaty override on the basis of the interpretation of national provisions clearly exposes the state to international responsibility.

This is the case for Germany, for example. According to the position prevailing both in literature and case law, treaty override is lawful within the national system, although it realizes a breach of international law<sup>21</sup>.

Only very recently, the German Federal Tax Court (Bundesfinanzhof) has taken a different position. On the basis of a different interpretation of the German Constitution, the Federal Tax Court has affirmed the illegitimacy of treaty override. Article 25 of the German Constitution states that ‘*The general rules of international law shall be an integral part of federal law. They shall take precedence over the laws and directly create rights and duties for the inhabitants of the federal territory.*’ Superseding its previous interpretation, the Federal Tax Court has considered the rule *pacta sunt servanda* included among the general rules of international law. As a consequence, also treaty provisions, by virtue of the rule *pacta sunt servanda*, can be considered prevailing over federal law under the German Constitution. The question has been submitted to the German Constitutional Court that, in the end, will decide about the admissibility of the ‘new’ Federal Tax Court’s interpretation.

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<sup>21</sup> See Rust, A., Germany, in Maisto, G., (editor), *Tax Treaties and Domestic Law*, EC and International Tax Law Series, Vol. 2, IBFD Publications BV, 2006, p. 237.



## *6.2 Consequences of tax treaty override on the overriding domestic legislation and on taxpayers: the need of an effectively binding international system*

The existence of a Constitutional Court within a national legal system is decisive when the issue concerning the consequences of tax treaty override on the overriding legislation is addressed.

Only a Constitutional Court can declare national legislation illegitimate because in conflict with the Constitution and repeal domestic legislation from the national legal system.

Absent a Constitutional Court, the domestic overriding legislation can only be set aside. In substance, it is not applicable for treaty purposes.

It is clear, however, that in case of judicial tax treaty override, which is determined by the application of domestic law in principle aimed at being applied for domestic purposes only, the effect can never be a declaration of illegitimacy. The only possibility is the non application of domestic law for treaty purposes.

Finally, a few considerations about taxpayer protection needs to be done.

Unfortunately, the possibilities of protection for taxpayers claiming the observance of international treaty obligations in a state that allows tax treaty override are substantially inexistent. All the international mechanisms to settle disputes have a consensual nature which excludes the possibility that a state acts in conflict with its own interests. Protection can be assured only indirectly when the domestic overriding legislation violates a specific domestic provision or it violates EU law. Treaty override in itself does not guarantee any possibility of judicial protection. Only in those states where treaty override is considered illegitimate, taxpayers can claim the violation of the specific provision forbidding the breach of international treaty obligations.

These conclusions lead to emphasize what Tanzi has defined the paradox of international law, i.e. the fact that international law is created by states and states are at the same time the addressees of international law. States have materially the possibility to breach international law.

In addition, the international mechanisms to settle disputes are based on the consensual participation of states. This, indeed, weakens the binding nature of international law.

Nevertheless, it is exactly this observation that – paradoxically – makes even more important to emphasize that international law has binding effects upon states whose sovereignty is objectively (non depended on the will of states) limited by the conclusion of an international agreement. The contrary position would imply to accept the fact that the more powerful states could decide to conclude agreements and at discretion override them.

On the contrary, the establishment that international law is objectively binding upon states is essential in order to guarantee a balanced functioning of the international community even when important national interests, like the protection of the national taxing power, are at issue.

A legal systematization of tax treaty override is, therefore, fundamental in order to balance the need to preserve the national tax base with the need to guarantee both legal certainty for taxpayers and market integration. Taxpayers need to be able to predict the tax consequences of their investments and, if necessary, receive judicial protection. Market integration necessarily presupposes stability of the international relations.

States and taxpayers need to be aware of the fact that international agreements, as means that reflect the common position of states, are fundamental instruments in order to create and maintain that balance which assures satisfaction of the common interest. Treaty override has the only consequence of disrupting nationally and internationally a balance that can be re-built only with extreme difficulties exactly because the available legal instruments are extremely limited.

For this reason the agreement needs to be carefully formulated. It is an important means to preserve the taxing power of the contracting states and, at the same time, to assure protection to taxpayers.

These considerations are even more important when one thinks about the many aspects of the OECD Model Convention that, as this study has partially showed, need to be improved. In this respect the bilateral nature of tax treaties based on the OECD Model Convention is certainly an advantage for the contracting parties.

In case of exit taxes it has been emphasized the fair right of the state of departure to tax income accrued during the period of residence of the emigrant taxpayer. Since this right is not protected by the OECD Model Convention, the most appropriate solution is to introduce a provision that explicitly allows the state of source to tax income accrued but not yet realized at the moment of emigration. This solution has already been proposed in the previous chapter four. An exit tax could be collected in the hands of previous residents at the moment of actual realization of capital gains or, in case of pension, when the pension starts to be paid or the pension claim is redeemed.

The provision should also take into consideration possible depreciations at the moment the tax is collected as well as interests accrued after emigration.

The practical difficulties concerning this solution would not be different than those already existing: a periodic exchange of information between the two states as well as a periodical declaration by the taxpayer confirming the ownership of the assets or that the pension claim has not been redeemed.

It is important to point out that a solution based on immediate taxation by the state of source upon emigration would not be compliant with EU law. Anyway, the same policy that has led the Court of Justice of the European Union to recognize the possibility to postpone the payment of an exit tax is, indeed, pertinent on an international level as well. Tax neutrality upon emigration of both companies and individuals favours economy (directly or indirectly – as in case of pensioners who move to another state) and should, therefore, be facilitated.

At the same time, I consider extremely important the introduction of specific and/or general anti-abuse clauses within tax treaties. This study has confuted the position of the OECD and demonstrated that conflicts can arise between domestic anti-abuse rules and tax treaty provisions. The introduction of specific and/or general anti-abuse provisions is indispensable in order to effectively guarantee the taxing power of the contracting states and preserve taxpayers against cases of double taxation when necessary. It is important to remark that in most of the cases CFC legislation applies even if there is no tax treaty abuse. This happens because CFC legislation does not usually recognize the possibility to prove the absence of abuse when a corporation is allocated in a country that guarantees a more favourable tax regime. In this case the application of CFC legislation determines a case of unjustified double taxation. The relationship between domestic anti-abuse rules and tax treaty provisions is a quite complicated matter that, indeed, requires a more coherent position of the OECD. As emphasized in chapter five, the OECD has, in fact, allowed its member countries to follow absolutely different and even opposite positions concerning the application of domestic anti-abuse rules when treaty provisions are at issue. The result is the adoption of different notions of treaty shopping that cause tax distortions. A clear and practicable position of the OECD is urgently needed. In the meantime – again – the contracting states have a fundamental instrument which is the agreement. The contracting states have the possibility to regulate all these fundamental aspects on a bilateral basis.

# Summary: Tax Treaty Override

## 1. Tax treaty override, general international law and state sovereignty

Purpose of this study was to identify the interpretative process that underlies the detection of cases of tax treaty override. As a consequence – and in parallel – the definition of tax treaty override has been developed in order to clarify some aspects that are still unclear or not taken into consideration both in literature and case law. This analysis has been conducted in order to develop an ‘interpretative model’ on which the individuation of cases of tax treaty override can be based.

Although tax treaty override is a quite frequent phenomenon in practice, until now no academic studies have provided a systematic analysis about this topic. The Report on treaty override elaborated by the OECD in 1989<sup>1</sup> was a quick reaction to the grave cases of tax treaty override that occurred in the United States in the 1980’s. Despite its theoretical and practical implications, tax treaty override has not been analyzed yet in a systematic way. On the contrary, the analysis about tax treaty override is still at a preliminary stage.

However, one point is clear: tax treaty override stems from a conflict between laws.

This conflict depends on the relationship between national and international law. More specifically, tax treaty override depends on the fact that states regulate the relationship between international and national law at discretion<sup>2</sup>. Indeed, international law does not derive from a representative organ, like a national parliament, the jurisdiction of international tribunals is voluntary<sup>3</sup> and there is no international centralized system of sanctions. Concretely, states have the possibility to decide what effect is to be attributed to international law within their territory.

In fact, some states apply international law automatically and directly, whereas other states subordinate the implementation of international law to its transformation and incorporation into national law. In the first case, treaty override is not admitted because international law prevails over national law. In the second case, treaty override is considered legitimate exactly because international law is transformed and incorporated into national law. Consequently, the rule *lex posterior abrogat priori* applies. This means that the law incorporating

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<sup>1</sup> OECD, *Tax Treaty Override*, OECD 1989.

<sup>2</sup> This has been demonstrated in the second chapter of this work where a country analysis has been addressed.

<sup>3</sup> Participation is based on consent.

the international treaty can be amended by a subsequent national law that has the same rank within the national hierarchy of law. From a strict national point of view this ‘mechanism’ is absolutely legitimate. States can transform international law and incorporate it into national law. At the same time, the rule *lex posterior abrogat priori* is a common applied interpretative rule. However, this ‘mechanism’ based on the incorporation of international law into national law and the subsequent application of the rule *lex posterior abrogat priori* determines the unilateral amendment of a previously concluded international agreement. It determines a treaty override. Indeed, this process is the manifestation of the reluctance of states to abandon a certain deeply rooted conception of state sovereignty. As a consequence, Cassese emphasized the conviction of states that *‘the translation of international commands into domestic legal standards is part and parcel of their sovereignty’*<sup>4</sup>. This is a crucial point of this study. Can still be accepted a notion of state sovereignty which allows states to unilaterally re-extend their rights after the conclusion of a valid international treaty ?

The point was, therefore, to understand whether state sovereignty is limited by international law.

If international law is objectively binding upon states, their sovereignty is limited by a valid international agreement whose effects cannot vary at discretion on the basis of the will of each individual state.

The theories of Lauterpacht and Tanzi have been applied in order to address this crucial issue.

Both authors recognize the objectively binding nature of international law as created by states which are the main actors within the international community.

According to Lauterpacht, *‘There is no reason why the original hypothesis in international law should not be that **the will of the international community must be obeyed [emphasis added]**. It could be said, by way of further explanation, that although in many cases the will of the international community must be deducted from the mere fact of its existence, i.e. from ‘the reason of the thing’, **the organs of the formation of the will of the international community are, in the absence of an international legislature, States themselves, their consent being given by custom or treaty, and being capable of impartial ascertainment and interpretation by international tribunals.** An initial hypothesis expressed in the terms of *voluntas civitatis maximae est servanda* would point, as the source of law, to the will of the international society expressing itself in contractual agreements between its constituent members, in their customs, and in the general principles of law which no civilized community can afford to ignore; it would refer to the *civitas maxima*, as meaning that super-State of law which **States, through the recognition of***

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<sup>4</sup> Cassese, A., *International Law*, Oxford University Press, second edition, 2005, p. 220.

*the binding force of international law qua law, have already recognized as existing over and above the national sovereignties; it would be compatible with the fact that the authority of that super-State extends, so far, not so much to the creation of new concrete rules as to the maintenance and respect of obligations already expressed or contracted by implication*<sup>5</sup>.

Perfectly in accordance, Tanzi maintains: 'Firstly, nation-states came into being *de facto*, claiming and attaining on the basis of reciprocity prerogatives and limitations that would make up the principle of sovereignty. Expectations and consequent claims of reciprocal conduct represent the meta-juridical and, at the same time, legal constituent element of the international legal community.

Secondly, such sovereign actors, so self-conceived and self-perceived, would produce and utilize rules on recognition, as well as the material rules thereby produced'.<sup>6</sup>

The same creative process is at the basis of the principle of sovereign equality which, according to Tanzi, is the 'true *grund-norm*'<sup>7</sup> of international law. This principle has a central role when an international agreement is concluded. Not only the equal position of the parties to it is guaranteed, but also the protection of reciprocity and legitimate expectations becomes essential.

International law has no parliamentary origin. However, this circumstance is not enough to exclude its binding effect. This is a consequence of the fact that international law is materially created by those subjects that are the main actors within the international community, i.e. by the states.

International law is literally 'created' by states through their action, i.e. through their participation in the international community. 'Expectations and consequent claims of reciprocal conduct' determine the passage from a material act of participation to recognition as *Law*. International law stems from the material creation by states and it reaches the status of *Law* through recognition and consent of states. To conclude, international law is binding upon states because it is based on the consent and recognition of states themselves. As a consequence international law limits state sovereignty.

At this point, a distinction needs to be made. It is important to recall that, as emphasized in the second chapter of this study, international law has no rules that oblige states to follow a specific procedure of implementation. As a consequence, states are allowed to incorporate and transform international law into national law. Nevertheless, this possibility cannot be a way to actually breach international law, in general, and an international agreement, more specifically. This means that the transformation into national law does not allow states to apply the rule *lex posterior abrogat priori* when its application concretely determines a unilateral

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<sup>5</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, pp. 429 - 430.

<sup>6</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 150.

<sup>7</sup> Tanzi, A., *Remarks on Sovereignty in the Evolving Constitutional Features of the International Community*, in *International Community Law Review*, Vol. 12 (2010), No. 2, p. 150.

amendment to the incorporated international agreement and, therefore, a treaty override.

In addition, art. 27 of the Vienna Convention on the Law of Treaties, by codifying a principle of customary law, states that a breach of an international agreement cannot be justified by virtue of national law.

In conclusion, even if, on the one hand, the international legal system allows states to transform international law into national law and, on the other hand, the application of the rule *lex posterior abrogat priori* is legitimate from a strictly national point of view, state sovereignty is limited through the conclusion of an international agreement. Consequently, a validly concluded international agreement forbids states from unilaterally re-extending their sovereignty through the application of the rule *lex posterior abrogat priori*. When this re-extension occurs international law is violated through the realization of a tax treaty override.

It is worth noting that the theory supported in the present study connects the limitation of the state sovereignty directly to the international agreement which is binding in itself. The rule *pacta sunt servanda* is not considered the source of the binding effects of an international agreement. This is an extremely important aspect of this study because the rule *pacta sunt servanda* is external to the international agreement and in addition it specifically concerns the performance of a treaty instead of its content.

The occurrence of a tax treaty override can be analyzed only with reference to the content of the international agreement and cannot depend on the scope and meaning of a rule which guarantees the effects of an international agreement but it is not the source of its legitimacy.

The importance of this differentiation is emphasized by Lauterpacht: ‘*The hypothesis pacta sunt servanda has proved a beneficent transition from a doctrine of international law based on the will of sovereign States to a doctrine of the law of nations based on the law’s impersonal sovereignty.*

*But at present it contains the two incongruous elements. It pays homage both to the will of States as the fountain of law and to the heteronomous command of the rule of law. But the synthesis is only one of words; it is not, and cannot be, one of substance. A more satisfactory solution can be found in a hypothesis which, by courageously breaking with the traditions of the past period, incorporates the rational and ethical postulate, which is gradually becoming a fact, of an international community of interests and functions.*’<sup>8</sup>

It is clear that if the objective binding nature of international law is recognized the rule *pacta sunt servanda* is also, as a rule of international law, objectively binding. On the contrary, when the objectively binding nature of international law is denied, the rule *pacta sunt servanda* either loses its objectively binding nature

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<sup>8</sup> Lauterpacht, H., *The Function of Law in the International Community*, Oxford University Press, 2011, p. 430.

and becomes depended on the will of states or it is considered a juridically indemonstrable rule<sup>9</sup>.

Immense is the variety of theories that, on the basis of even completely opposite points of view, explain the nature of international law.

Lauterpacht and Tanzi have a common starting point in evaluating the nature of international law. This starting point is the existence of an international community. This is the reason that led me to found this study on their theories. International law does not stem from an organ with representative function, like a national parliament. In addition, the jurisdiction of international tribunals is only consensual. However, states have created an international community where they operate politically, economically and socially every day. The existence of an international community imposes the existence of law that governs that community. After all, states acting within the international community create rules because they need rules that govern their relationships. It is not possible to apply these rules at discretion. It would imply to admit that the international community is governed by power and that states accept unequal relationships between themselves. However, the existence of the United Nations, the existence of international tribunals, the existence of the European Convention on Human Rights and the relative Court show that, although – undoubtedly – power still has a big impact on the effect of international law, the direction of the international community as a whole is at the opposite. This direction can be guaranteed only through a coherent acceptance of the binding effect of international law.

## **2. Legislative treaty override as a *legal injury* under the Draft Articles on State Responsibility**

It is a general principle of the international legal system that any violation of international law gives rise to state responsibility. Already in the late twenties of the last century the Permanent Court of International Justice stated that *'[i]t is a principle of international law that the breach of an engagement involves an obligation to make reparation in an adequate form. Reparation therefore is the indispensable complement of a failure to apply a convention and there is no necessity for this to be stated in a convention itself.'*<sup>9 10</sup>

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<sup>9</sup> In this respect, see chapter II.

<sup>10</sup> Permanent Court of International Justice, *Factory at Chorzów* case, Series A, No. 9, judgment No. 8, 26 July 1927, p. 21; Permanent Court of International Justice, *Factory at Chorzów* case (Merits), Series A, No. 17, judgment No. 13, 13 September 1928, p. 29.



In the *Interpretation of the Peace Treaties case (Second Phase)*, the International Court of Justice stated: ‘... it is clear that refusal to fulfil a treaty obligation involves international responsibility’<sup>11</sup>

This fundamental principle of international responsibility is now clearly established by the ‘Draft Articles on Responsibility of States for Internationally Wrongful Acts’<sup>12</sup>. Its article 1 states that ‘every internationally wrongful act of a State entails the international responsibility of that State.’

Article 2 specifies that ‘there is an internationally wrongful act of a State when conduct consisting of an action or omission: (a) is attributable to the State under international law; and (b) constitutes a breach of an international obligation of the State.’

Article 2 of the draft articles does not mention damage as a constituent element of an internationally wrongful act.

Moreover, the Commentary to draft article 2 specifies that the need of a material or moral damage to occur in order to make state responsibility arising depends exclusively on the content of the primary obligation<sup>13</sup>. The material or moral damage is an indispensable element of state responsibility only when it is required by the primary obligation. This is confirmed by draft article 12 which specifies that ‘there is a breach of an international obligation by a State when an act of that State is not in conformity with what is required of it by that obligation, regardless of its origin or character’.

Since the Draft Articles on State Responsibility are based on the concept of ‘absolute responsibility’ – as it appears clear from the mentioned provisions – any breach of a treaty provision which results in an act that is not in conformity with the terms of that provision is an internationally wrongful act<sup>14</sup>.

Given these premises, tax treaty override can be qualified as a wrongful act that gives rise to international responsibility of states.

Nevertheless, there is a contradiction between the first and the second part of the draft articles. While draft articles 1 and 2 only require the violation of an international obligation in order to qualify an internationally wrongful act, according to draft article 31, reparation is only possible in case a material or moral damage has been caused. Draft article 31(2) states that ‘injury includes any

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<sup>11</sup> International Court of Justice, Advisory Opinion of 18 July 1950 – Interpretation of Peace Treaties with Bulgaria, Hungary and Romania (Second phase), p. 228.

<sup>12</sup> Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, 2001. The text of the draft articles is reproduced in the Annex of a United Nations General Assembly resolution adopted on the 12<sup>th</sup> of December 2001 (A/RES/56/83).

<sup>13</sup> Draft articles on Responsibility of States for Internationally Wrongful Acts, with commentaries, cit., Commentary on art. 2, par. 9, p. 36.

<sup>14</sup> Shatabai, R., *Breach of Treaty in the Codification of the Law of State Responsibility*, Martinus Nijhoff Publishers, 2007, p. 517.

damage, whether **material or moral [emphasis added]**, caused by the internationally wrongful act of a State’.

Furthermore, ‘the provisions on restitution (Article 35) and compensation (Article 36) seem intended to make reparation for a material injury, and satisfaction (Article 37) for a moral one’<sup>15</sup>.

In substance, the Draft Articles on State Responsibility do not explicitly state the right to obtain reparation in absence of a material or moral damage. And it is clear that if reparation is not guaranteed – in fact – there is no responsibility.

This raises doubts about the possibility that a legislative tax treaty override, which is based on the sole conflict of laws and is, therefore, a legal injury, can give rise to state responsibility under the Draft Articles on State Responsibility.

As clarified in the course of this study, a judicial tax treaty override is based on the actual application of domestic law that, being adopted after the conclusion of a tax treaty, determines a material extension of the taxing power of the amending contracting state. Consequently, the tax base in the other contracting state results eroded. In short, a judicial tax treaty override causes a damage to the other contracting state.

On the contrary, no damage – at least moral or material – is caused when a legislative tax treaty override occurs. A legislative tax treaty override stems from the mere conflict between domestic law and a previous treaty.

This conflict as such realizes a violation (through a *de facto* unilateral amendment) of a tax treaty but it does not cause a material or moral damage to the other contracting state.

I agree with Tanzi and Barboza when they maintain that a violation of international law inherently causes a breach of the legal system and, therefore, the violation of a subjective legal interest of the injured state. Although no material or moral damage is caused, the sole breach of an international obligation weakens both the international legal order and the specific rights of the injured State.

Agreeably, Barboza connects the first and the second part of the Draft Articles on State Responsibility by arguing that the ultimate aim of the draft articles in general and of draft article 1 specifically is ‘the return to legality’<sup>16</sup>.

In addition, the commentary on draft article 31 makes it clear that the notion of reparation which is applicable is that established by the Permanent Court of International Justice in the representative *Factory at Chorzów* case : ‘*The essential principle contained in the actual notion of an illegal act - a principle which seems to be established by international practice and in particular by the decisions of arbitral tribunals - is that reparation must, as far as possible, wipe out all the consequences of the*

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<sup>15</sup> Barboza, J. *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, p. 9.

<sup>16</sup> Barboza, J. *Legal Injury: the Tip of the Iceberg in the Law of State Responsibility?*, in M. Ragazzi (editor) *International Responsibility Today. Essays in Memory of Oscar Schachter*, Martinus Nijhoff Publishers, 2005, pp. 10, 22.

*illegal act and reestablish the situation which would, in all probability, have existed if that act had not been committed [emphasis added].*<sup>17</sup>

In short, this means that reparation should essentially guarantee ‘return to legality’.

The need of returning to legality allows to include ‘legal injury’ within the notion of internationally wrongful act. Thus, legislative tax treaty override can be considered an internationally wrongful act that gives rise to state responsibility.

### 3. An ‘interpretative model’ to identify cases of tax treaty override

The conclusion that an international agreement is binding in itself and it concretely limits state sovereignty so that the extent of the sovereignty of states cannot be considered discretionally depended on their will has had a major impact on the analysis specifically concerning tax treaty override. The international agreement is the only parameter to evaluate the possible occurrence of a tax treaty override. For this reason this study has considered extremely important an in depth analysis about the peculiar structure and functioning of the OECD Model Convention. The close and almost inextricable interrelation between tax treaty provisions and domestic law has been illustrated to clarify how difficult it can be to individuate the exact balance that a tax treaty creates between them. Individuating this balance means to individuate to what extent the contacting states sovereignty has been limited. The OECD Model Convention is mainly constituted by formal distributive rules while taxation is based on substantive domestic law. The relevant distributive rule is the point of reference in an interpretative process aimed at establishing whether a case of tax treaty override has occurred.

Vogel’s model of distributive rule has been applied in this study in order to concretely understand the measure of the incidence of a tax treaty based on the OECD Model Convention on the application of domestic taxing law.

The interpretative process developed in the main part of this study has been synthesized in the following ‘interpretative model’:

1. The rightly applicable distributive rule needs to be individuated. The individuation of the rightly applicable distributive rule needs to be based on the qualification of the relevant item of income or capital by virtue of its very nature, i.e. its source;
2. The exact relationship between the constituent elements of the relevant distributive rule and domestic law needs to evaluate. Vogel’s model of distributive rule can be used for this purpose. It is necessary to establish

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<sup>17</sup> Permanent Court of International Justice, *Factory at Chorzów case (Merits)*, Series A, No. 17, judgment No. 13, 13 September 1928, p. 47.

to what extent state sovereignty has been limit, i.e. to what extent the possibility to apply domestic law has been limited. The exact relationship between the domestic taxing provisions and the treaty relieving provisions needs to be established;

3. If the rightly applicable distributive rule uses terms which are not defined within the text of the relevant treaty art. 3(2) of the OECD Model Convention mandatorily applies. The state that applies the treaty uses the domestic definition applied within the state of source<sup>18</sup>. The domestic definition is used as existing at the moment the treaty is applied unless the context otherwise requires. Precedence is given to a domestic investigation about the correspondent domestic definition even if it has been modified after the conclusion of the relevant tax treaty (ambulatory interpretation). Only if the treaty context requires otherwise, which also means that the context can clearly be considered the expression of the common intention of the parties, a contextual definition will apply. The treaty context could also limit the possibility of an ambulatory interpretation and requires the application of a term as defined under domestic law at the moment of the conclusion of the relevant treaty. Treaty context and domestic law can also be mutually applied. When the treaty context does not contain an exhaustive definition but only elements that delimit the domestic definition, this domestic definition will be applied within the limits established by the context. The OECD Commentaries are also included within the notion of context. It is, however, necessary to prove that in the concrete case at issue they actually express the common intention of the contracting states. The applicable OECD Commentaries are those existing at the moment of the conclusion of the relevant treaty. Art. 3(2) also admits fictitious definitions to the extent that they are compatible with the wording and context of the relevant distributive rule. In general, the use of the terms 'derived' and 'paid to' excludes the possibility to use fictitious qualifications of items of income and capital;
4. When the relevant item of income or capital is domestically qualified on the basis of fictions or lump-sum applies the compliance of this fictitious qualification or the use of lump-sum needs to be evaluated on the light of the previous qualification based on the very nature of the item of income or capital at issue on the basis of its real source;
5. In particular, an amendment subsequent to the conclusion of the relevant tax treaty cannot recharacterize items of income and capital or introduce the payment of lump-sum that determine a shift in the taxing power of the contracting states. This amendment is illegitimate when it determines the

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<sup>18</sup> For the exceptional cases when this rule does not apply, see chapter IV, footnote No. 29.

application of a distributive rule favourable to the amending contracting state but which is not the distributive rule rightly applicable on the basis of the qualification of the relevant item of income or capital on the basis of its very nature. In this case a tax treaty override occurs;

6. Fictions regarding the residence of taxpayers cannot completely lack a nexus with the state claiming taxing rights. When a provision concerning fictitious residence is introduced after the conclusion of the relevant tax treaty and it is not based on any concrete nexus with the state claiming taxing rights, there is an illegitimate attribution of taxing power that determines a case of tax treaty override;
7. More in general, tax treaty override occurs whenever an amendment subsequent to the conclusion of a tax treaty extends the taxing power of the amending contracting state beyond the limits established by the relevant distributive rule so that domestic taxing legislation results wider than the treaty relieving provisions;
8. A tax treaty override is furthermore realized when domestic legislation which has been unilaterally introduced after the conclusion of a tax treaty has the actual purpose of preventing the application of the treaty;
9. Saving clauses can be introduced in the specific tax treaty;
10. Anti-abuse clauses can be introduced in the specific tax treaty;
11. When more than one interpretation is possible, priority needs to be given to the interpretation that conciliates the application of both domestic law and treaty provisions.

#### **4. A definition of tax treaty override and all its constituent elements**

For general international law purposes the term ‘treaty override’ refers to any breach of an international agreement in accordance with the common meaning of the verb ‘override’ (or ‘overrule’ which is also commonly used to indicate that a treaty has been superseded). The term ‘treaty override’ has instead acquired a specific connotation for tax treaty purposes.

‘Tax treaty override’ can be defined as the unilateral amendment of an international treaty through domestic legislation adopted or applied by one of the contracting states after the moment the treaty has become binding upon its parties.

Tax treaty override, therefore, stems from a conflict between laws: domestic legislation is in conflict with one or more provisions of a previous international treaty.

A specific characteristic of tax treaty override derives from the absolutely peculiar structure and functioning of the OECD Model Convention. While taxation is governed by domestic law, tax treaties based on the OECD Model Convention are mostly made of only formal distributive rules which limit the application of domestic taxing legislation. Thus, the OECD Model Convention determines the application for tax treaty purposes of legislation which is in principle adopted for domestic purposes only. As a consequence, the moment a tax treaty override is actually realized depends on the scope of domestic law. When its scope exactly coincides with the scope of one or more provisions of a previous international treaty and domestic law is specifically meant to apply for tax treaty purposes as well, a tax treaty override is realized at the moment domestic law is passed by a national parliament. This was, for example, the tax treaty override realized when in 2005 the application of the Canadian GAAR was extended – with retrospective affect – to apply in respect to all the existing tax treaties<sup>19</sup>.

Different is the case when newly adopted or amended domestic law is not meant to be applied for tax treaty purposes. This could, for example, be the case of the Dutch ‘typical wage rule’<sup>20</sup>. That legislation was a domestic legislation in principle meant to apply for domestic purposes although, given its content, possibly applicable for treaty purposes as well. In this case, the mere adoption of domestic law cannot realize a tax treaty override. This clearly depends on the fact that a tax treaty cannot limit the sovereignty of contracting states in order to adopt or amend domestic law. In this case a tax treaty can only limit the right of a contracting state to apply domestic law for treaty purposes when domestic law is in conflict with the relevant treaty. In this case the actual realization of a tax treaty override is subordinated to the application of domestic law.

The distinction between the moment domestic legislation is passed by a national parliament and its application is consequently at the base of the distinction between legislative tax treaty override and judicial tax treaty override. In the first case a tax treaty override stems from the mere conflict between national law and one or more provisions of a previous international treaty. A legislative tax treaty override is, therefore, possible only when there is exact coincidence between the scope of domestic law and the scope of one or more provisions of an international treaty and, in addition, domestic legislation is specifically adopted for treaty purposes. This usually happens when the domestic legislature expresses its will to override one or more tax treaties (commonly the overriding will is expressed with regard to all the concluded tax treaties). The 2005 amendment

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<sup>19</sup> See chapter V.

<sup>20</sup> See chapter IV.

to the UK re-entry charge was expressly said to apply notwithstanding the provisions of any concluded tax treaty<sup>21</sup>.

Judicial treaty override is – by definition – based on the application of domestic law. In this case the relevant domestic law has the same scope of one or more provisions of a tax treaty but it is not specifically meant to apply for treaty purposes as well. Domestic law was adopted for internal purposes only. However, the coincidence of scope between domestic law and one or more tax treaty provisions makes domestic legislation possibly applicable for treaty purposes as well. When this legislation is applied by a national court in conflict with a previous treaty a case of judicial tax treaty override is realized.

It is clear from the above that the express intention of the legislature in order to override a tax treaty is not an essential element characterizing tax treaty override. It has been explained that in case of legislative tax treaty override the scope of domestic law needs to be expressly extended in order to apply for treaty purposes as well. However, this does not necessarily imply the express intention to override a tax treaty. It only implies the intention to apply domestic law for treaty purposes as well, regardless of the awareness of the legislature that a treaty override is in fact being realized.

Judicial treaty override is based on a judicial decision. A judge can intentionally override a treaty or simply realize a treaty override without being aware of it. Roxan explained that *‘[a] judicial override may arise because a court is suspicious that provisions of the convention may have a ‘disruptive’ effect on the domestic tax system. More innocently, it may arise simply because the court is less familiar with the interpretation of tax conventions than with the interpretation of domestic tax legislation. The court may thus find it easier to reach a conclusion by applying purely domestic tax principles.’*<sup>22</sup> In short, a judicial tax treaty override can also be the result of an incorrect application of international law (included the case when national law is incorrectly applied instead of international law).

Finally, the distinction between legitimate and illegitimate tax treaty override needs to be clarified.

As explained above, a treaty override determines a unilateral modification of the agreement as originally made between the parties. It is, however, possible that a tax treaty itself allows to a certain extent an amendment to the original agreement. The analysis of art. 3(2) of the OECD Model Convention has showed that the possibility of an ambulatory interpretation, in fact, allows a partial modification of the original agreement by admitting the application of a

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<sup>21</sup> See chapter VI.

<sup>22</sup> Roxan, I., *Judicial Overrides of Double Tax Conventions: The Case of a Permanent Establishment*, in *Intertax*, Vol. 25 (1997), No. 11, p. 367.

domestic definition as amended after the conclusion of the relevant treaty. A tax treaty is, in fact, overridden. However, the parties to the treaty have explicitly agreed upon it. A tax treaty override is realized but this is a case of legitimate treaty override because it is established by the parties to the relevant treaty. For the same reason, it should be excluded that, at least on the basis of the OECD Model Convention, treaty abuse can be considered a justification to override a tax treaty. Unless the contracting states have specifically agreed on the possibility that domestic law can be applied notwithstanding the provision of a tax treaty, abuse does not give rise to a legitimate case of tax treaty override.

## 5. The application of the interpretive model

### 5.1 *The U.S. exit tax regime*

The developed interpretative model has been, first of all, applied to the U.S. exit tax regime introduced in 2008. Section 877A (a)(1) of the Internal Revenue Code establishes '*[a]ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value*'.

Since the legislation at issue covers all property, even personal property, owned at the moment of transfer, evaluation about tax treaty override should entail each relevant distributive rule individuated on the basis of the very nature of the specific item at issue. The application of the interpretative model conducted in chapter six covered shareholding and, therefore, taxation of capital gains. The choice was made in order to extend this examination to one of the most common exit tax regime so that more general outcomes could be inferred from the conducted analysis.

The simulation regarded the tax treaty concluded between the U.S. and the Netherlands in 1992.

Two conflicting aspects were highlighted. Essentially, a tax treaty override was realized through the introduction of a fiction – '*[a]ll property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value*' – that by anticipating the moment when tax liability arises – in fact – precludes the application of the relevant tax treaty.

In addition, it has been emphasized that the application of an exit tax is legitimate from a domestic point of view only when the state of origin has actually lost its unlimited taxing power on the emigrant taxpayer. This means that an exit tax can be applied only when the taxpayer is, in fact, no longer resident in the state of departure. A tax treaty override is, therefore, realized every time, in breach of art. 13(5) of the OECD Model Convention (the simulation took into consideration the correspondent art. 14(7) of the treaty between the U.S. and the Netherlands) the state of origin exercises its taxing power on a subject which is no longer resident there.



For this reason the introduction of the U.S. saving clause (the treaty concluded between the U.S. and the Netherlands does not contain a saving clause) could avoid a tax treaty override by allowing taxation in the hands of previous residents. The latest version of the saving clause is contained in art. 1(5) of the 2006 U.S. Model Convention. It reads: *'Except to the extent provided in paragraph 5, this Convention shall not affect the taxation by a Contracting State of its residents (as determined under Article 4 (Resident)) and its citizens.'*

*Notwithstanding the other provisions of this Convention, a former citizen or former long-term resident of a Contracting State may, for the period of ten years following the loss of such status be taxed in accordance with the laws of that Contracting State'*

In chapter four it has been emphasized that the OECD Model Convention does not contemplate the case of transfer of residence. Consequently, the right of the state of source to tax accrued income is not protected.

The only way to assure that the state of source can rightly tax income accrued – although not realized during the period of residence – is the introduction of an express provision within tax treaties.

The concept which is at the basis of the U.S. saving clause is a good starting point. A tax treaty should clearly establish the right of the state of source to tax, at the moment of realization, income that accrued during a previous period of residence.

## 5.2 The UK 're-entry charge'

The interpretative model has subsequently been applied to the UK re-entry charge. I found it interesting to verify whether taxation of capital gains at the moment of return to the state of origin could be a regime admissible under the OECD Model Convention and might represent a solution for those countries that now apply a common exit tax regime.

The legislation at issue is quite peculiar. It is also founded on a fiction. Capital gains realized abroad, by an individual who was resident or ordinarily resident in the UK, on assets that the taxpayer owned while he was resident or ordinarily resident in the UK, are deemed to have been realized in the year of return to the UK.

The anti-avoidance purpose of the legislation at issue is clear. When the taxpayer transfers its tax residence from the UK but he remains abroad only for a short period of time (according to the UK legislation, less than five years), it can be assumed that the transfer was aimed at realizing capital gains abroad. In this case, capital gains are deemed to be realized only in the year of return to the UK and taxed there.

The legislation at issue applies to capital gains in general. This means that the different relevant distributive rules should be examined, on the basis of the specific source of the capital gains, in order to analyze cases of tax treaty override. With the purpose to assure the examination of one of the most important and common situations, shareholding has been taken into consideration in the

analysis conducted in chapter six. In this way, coherently with the previous analysis concerning the U.S. regime, the examination had a wide scope and its outcomes can be considered to cover exit tax regimes as well.

UK law was tested under the tax treaty concluded between Italy and the United Kingdom in 1990. Art. 13(4) of the treaty (corresponding to art. 13(5) of the OECD Model Convention) was at issue.

In the specific simulation, the introduction of the re-entry charge in 1998 did not realize a tax treaty override. It was avoided thanks to art. 13(5) of the relevant tax treaty. This article states: *‘The provisions of paragraph (4) of this Article shall not affect the right of a Contracting State to levy according to its law a tax on gains from the alienation of any property derived by an individual who: (a) is a resident of the other Contracting State; and (b) has been a resident of the first-mentioned Contracting State at any time during the five years immediately preceding the alienation of the property; and (c) is not subject to tax on those gains in the other Contracting State’.*

Since Italy does not tax capital gains accrued on shareholding held by individuals, the introduction of the mentioned saving clause avoided the realization of a tax treaty override.

However, the analysis of art. 13(4) of the treaty concluded between Italy and the UK, in the light of Vogel’s model of distributive rule, has showed that, in principle, the UK re-entry charge is not compliant with the OECD Model Convention. In this case a deemed alienation is not at issue. Capital gains are realized on the basis of a real act of disposal. Nevertheless, they are realized abroad while the taxpayer is resident abroad. The UK regime imposes taxation of capital gains that are fictitiously considered to have been realized in the UK. The discrepancy with art. Art. 13(4) (which corresponds to art. 13(5) of the OECD Model Convention) was immediately evident on the basis of Vogel’s model of distributive rule. The article states *‘Gains from the alienation of any property other than that referred to in the preceding paragraphs of this Article shall be taxable only in the Contracting State of which the alienator is a resident’.* Clearly, the treaty provision at issue, analogously to art. 13(5) of the OECD Model Convention, establishes simultaneity between the status of being a resident of a certain state, the alienation by the same resident in the state of residence, and the right to tax of the same state.

This is exactly the problematic point in the UK legislation at issue. It extends the UK taxing power beyond the limits established by the relevant distributive rule. UK law – again by virtue of a fiction – attributes the taxing power to the UK while capital gains are realized abroad during a period when the taxpayer is resident abroad. Consequently, only the state where the capital gains are realized while the taxpayer was resident there has the right to tax (unless a saving clause is introduced!).

### 5.3 The transactional CFC method

Finally, the compliance of the CFC transactional method with the OECD Model Convention has been tested in the light of the developed interpretative model. The peculiarity of this CFC method depends on the fact that it covers only specific items of income. Transactional CFC regimes usually cover passive income and so-called base company income<sup>23</sup>.

Establishing the compliance of the CFC transactional method with the OECD Model Convention presupposed to individuate what distributive rules could be considered relevant: art. 7 of the OECD Model Convention which regulates business profits or the distributive rules individually relevant (in the most common situations, articles 10, 11 and 12 respectively governing taxation of dividends, interests and royalties).

In order to conduct this evaluation, the analysis developed in chapter five, which was dedicated to domestic anti-abuse rules and specifically to CFC legislation, was preliminarily essential. In chapter five the position of the OECD according to which domestic anti-abuse provisions, including CFC legislation, do not affect tax treaties has been confuted. Consequently, it has been proved that conflicts can arise between domestic anti-abuse rules and tax treaty provisions. This means that when domestic anti-abuse provisions, including CFC legislation, are in conflict with a previously concluded tax treaty, a tax treaty override can occur. In this case, the possibility to apply the relevant domestic legislation needs to be evaluated on the basis of the specifically applicable distributive rule.

Given these premises, it is clear that when the transactional CFC method is at issue, its compliance with the OECD Model Convention depends on the specific items of income covered. On the basis of the very nature of each item of income the relevant distributive rule is individuated and analyzed in order to verify to what extent the taxing power of the state that wants to apply the CFC legislation has been limited.

In the specific simulation conducted in chapter six, royalties have been taken into consideration. It has been demonstrated that art. 12 of the OECD Model Convention does not allow to tax the royalties received by the controlled foreign corporation in the hands of its foreign shareholders. According to art. 12, royalties can be taxed only in the state of residence of the CFC (when it is also beneficial owner). Art. 12 of the OECD Model Convention establishes that the taxable object (royalties) can be exclusively attributed to a specific taxable subject (the CFC which is beneficial owner of the royalties) No parallel attribution of taxable object to taxable subject is allowed by virtue of CFC legislation.

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<sup>23</sup> 'The base company income comprises the supply of services - and in some cases even the supply of goods - under certain circumstances, especially where the domestic shareholder or other group companies are somehow involved in the transactions.' See Bader, R. G., *CFC Legislation in the European Union and the Alternative CSC Concept*, (thesis defended at Tilburg University), 2012, p. 228.

In addition, art. 12 subordinates taxation of royalties to their actual payment. According to the OECD Commentaries, 'payment' has a concrete meaning that involves the obligation to transfer funds to the creditor. It is excluded that the mere attribution of royalties to the foreign shareholders of a controlled foreign corporation could legitimate taxation under art. 12 of the OECD Model Convention.



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